The NFTC Foreign Income Project:

International Tax Policy

for the

21st Century

Part Two

Relief of International Double Taxation

Chapter 1 Origins of the Foreign Tax Credit

I. Introduction

The United States' current system for taxing international income was created during the period from 1918 through 1928.[1] From the introduction of the income tax (in 1913 for individuals and in 1909 for corporations) until 1918, foreign taxes were deducted in the same way as any other business expense.[2] In 1918, the United States enacted the foreign tax credit,[3] a unilateral step taken fundamentally to redress the unfairness of "double taxation" of foreign-source income. By way of contrast, until the 1940s, the United Kingdom allowed a credit only for foreign taxes paid within the British

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[1] For further description and analysis of this formative period of U.S. international income tax policy, see Michael J. Graetz & Michael M. O'Hear, *The 'Original Intent' of U.S. International Taxation*, 46 DUKE L.J. 1021, 1026 (1997) [hereinafter "Graetz & O'Hear"]. The material in this chapter is largely taken from this source.

[2] The reasoning behind the international tax aspects of the 1913 Act is difficult to discern from the historical sources. One scholar has concluded "it is quite likely that Congress gave little or no thought to the effect of the Revenue Act of 1913 on the foreign income of U.S. persons or the U.S. income of foreign persons." Alan G. Choate et al., *Federal Tax Policy for Foreign Income and Foreign Taxpayers—History, Analysis and Prospects*, 44 TEMPLE L.Q. 441 (1971). The decision made in 1913 to tax the worldwide income of taxpayers may have simply followed the earlier, 1909, decision to make worldwide income subject to the 1909 federal excise tax on corporate income. *See* Corporation Excise Tax of 1909, ch. 6, § 38, 36 Stat. 11, 112-17.

[3] Revenue Act of 1918, ch. 18, 40 Stat. 1057, §§ 222(a)(1) (individuals), 238(a) (corporations), 240(c) (describing creditable taxes). The Revenue Act of 1918 also adopted the indirect foreign tax credit, which allows U.S. companies a tax credit for foreign taxes paid by their controlled foreign subsidiaries. Revenue Act of 1918, § 240 (c). The Revenue Act of 1918 is misleadingly named as it was actually enacted in 1919. Originally drafted in a special session of Congress during the summer of 1918, the Act was passed by the House in late September 1918; however, the Senate could not complete its deliberations until after the Armistice of November 11, 1918. Peace necessitated a certain amount of redrafting, which prevented final Senate action until February 1919. JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 85 (1995) [hereinafter "Witte"].

Empire and limited the credit to a maximum of one-half of the U.K. tax on the foreign income.[4] A few countries at that time protected residents from double taxation by taxing only domestic-source income.[5]

The Revenue Act of 1921, the first major tax act after World War I, introduced a limitation on the foreign tax credit to ensure that a taxpayer's total foreign tax credits could not exceed the amount of the U.S. tax liability on the taxpayer's foreign-source income.[6] This limitation was enacted to prevent taxes from countries with income tax rates higher than those of the United States from reducing U.S. tax liability on U.S.-source income.[7] While the details of the foreign tax credit have changed substantially since its introduction in 1918, these provisions still constitute the basis of U.S. law for taxing income earned abroad by U.S. citizens and residents.

In 1928, the League of Nations issued draft model bilateral income tax treaties for the reciprocal relief of double taxation of international income. Those League of Nations models still serve as the basis for the model income tax treaties of the Organisation for Economic Cooperation and Development (OECD), the United Nations and the United States.[8] Although, like U.S. tax law, treaty articles have become more complex, commentaries have become more detailed and some apparent loopholes have been closed, the 1928

[4] *See* Graetz & O'Hear, *supra* note 1, 1045-1048. The United Kingdom had previously allowed foreign tax credits for taxes paid within the British Commonwealth. Thomas S. Adams, *Interstate and International Double Taxation*, LECTURES ON TAXATION 101, 102 (Roswell Magill ed., 1932).

[5] For a discussion of other limited relief measures that were in existence prior to the U.S. foreign tax credit, *see* JOHN G. HERNDON, JR., RELIEF FROM INTERNATIONAL DOUBLE TAXATION: THE DEVELOPMENT OF INTERNATIONAL RECIPROCITY FOR THE RELIEF OF DOUBLE INCOME TAXATION 10-14 (Callahan & Company, Chicago 1932) [hereinafter "Herndon"] (describing legislation in the Netherlands, Belgium, Norway, and Switzerland). The Netherlands was the other large capital exporter of the time. *See* also T.C. JEN, DOUBLE TAXATION 4 (1924) (unpublished manuscript, available in T. S. Adams Papers, Yale University, Box 29, folder covering May-August 1924) (describing the income taxes of Australia, New South Wales, and South Africa).

Among the U.S. states, New York would soon introduce an income tax that provided a credit to residents for taxes paid to another state, but only if the other state also had an income tax and provided a similar credit or exception for New Yorkers. Edwin R.A. Seligman, *The New York Income Tax*, 34 POL. SCI. Q. 521, 534 n.1 (1919). Wisconsin also provided a tax credit to prevent double taxation, though double taxation of a different kind: Wisconsin permitted taxpayers to offset their personal property taxes against income taxes. ELLIOTT BROWNLEE, PROGRESSIVISM AND ECONOMIC GROWTH: THE WISCONSIN INCOME TAX, 1911-1929, at 62 (1974).

[6] Revenue Act of 1921, ch. 136, 42 Stat. 227, §§ 222(a)(5) (individuals), 238(a) (corporations). This limitation was intended to ensure that U.S. companies and individuals could not use foreign taxes to reduce or eliminate U.S. taxes on U.S.-source income. *See* the discussion of the 1921 Act in Graetz & O'Hear, *supra* note 1, and Chapter 1.III of this Report.

[7] *See* Graetz & O'Hear, *supra* note 1,1054-1056.

[8] Some early 19th century double taxation agreements are on record, including a Dutch measure dating from 1819 exempting foreign ships from the Dutch business-license tax on condition of reciprocity. See Mitchell B. Carroll, *Double Taxation Relief, Discussion of Conventions Drafted at the International Conference of Experts, 1927 and Other Measures*, DEPARTMENT OF COMMERCE TRADE INFORMATION BULLETIN NO. 523, 1 (1927) [hereinafter "Carroll"]. The modern treaty era began with the Prussia-Austria double taxation agreement of 1899.

League of Nations model, formulated more than seven decades ago, remains the common source of the roughly 2,000 bilateral tax treaties now in force throughout the world.

Despite massive changes in the world economy, the United States' international tax regime formulated in the 1920s has survived largely intact. The complexities of current U.S. tax law governing international transactions undoubtedly would shock a tax practitioner of the 1920s. Nor could those who fashioned the League of Nations' model income tax treaty of 1928 have foreseen the current integration of the world economy, or the expansion and sophistication of international capital flows. Nevertheless, the basic principles of both the 1920s United States' international tax law and the 1928 model treaty still govern the income tax consequences of international transactions. Nothing comparable to the multilateral restructurings of international monetary and trade relationships that followed World War II occurred in the context of international income taxation.[9]

The international tax dilemmas that confronted the Congress in the early days of the income tax remain essentially unchanged today. When income is earned in one country by a citizen or resident of another country, both the country where the income is earned (the source country) and the country where the investor or earner resides (the residence country) have legitimate claims to tax the income. The basic task of international income tax rules is to resolve the competing claims of residence and source countries to avoid the double taxation that will result when both fully exercise their taxing powers. Capital-importing countries have the most to gain from taxation at source, capital-exporting countries from the taxation of residents. In the absence of bilateral or multilateral agreements, residence countries are unable to limit the unilateral actions of source countries.

[9] Professor Richard Vann of Australia has described this circumstance as follows:

> Although it is possible to refine the actual terms of the OECD Model and to elaborate the commentary so as to cover new cases as they arise, the time has passed for radical revision within the current bilateral framework. In a sense the opportunity to go in another direction was lost before the 1963 draft appeared. The failure to adopt any new approach to international tax after the Second World War (compared to trade law and the international monetary system) meant that effectively the solution adopted after the First World War continued by default. In other words the OECD Model is the culmination of 50 years of development, rather than a new departure.

Richard J. Vann, *A Model Tax Treaty for the Asian-Pacific Region?*, 45 BULL. INT'L FISCAL DOCUMENTATION 99, 103 (1991).

II. Enactment of the Foreign Tax Credit in 1918

The Revenue Act of 1918 was enacted to raise revenue to finance World War I, a strange context for the introduction of what was to become the United States' first enduring contribution to international tax policy, the foreign tax credit. The foreign tax credit was, in fact, only a small part of a large, complex, and controversial bill.

Because the United States taxed the worldwide income of its citizens, the pre-1918 situation permitted double taxation, with foreign-source income being subject to taxation both at home and abroad. When the U.S. income tax was first introduced in 1913, tax rates were low and double taxation may have been a relatively minor issue. In 1918, however, with the world at war and tax rates rising rapidly around the globe, international double taxation was becoming a more serious burden on Americans doing business or investing abroad.[10] The top marginal rates in the United States on individuals reached 77 percent in 1918 and, although the basic corporate rate was only 10 percent, an excess profits tax at rates ranging from 8 to 60 percent also applied to many large companies.[11] In such circumstances, additional taxation by other countries was potentially confiscatory.[12]

The foreign tax credit provided U.S. citizens and residents with a credit against U.S. taxes for taxes paid to other countries.[13] The foreign tax credit represented a very generous measure: the United States was assuming sole

[10] *See, e.g.*, Hearings Before the Committee on Ways and Means on the Proposed Revenue Act of 1918, Pt. 1, 648, 649-650 (June 7-July 17, August 5, 14, 15, 1918) (Statement of Phanor J. Eder, Secretary, Mercantile Bank of the Americas). *See also* Clyde J. Crobaugh, *International Comity in Taxation*, 31 J. Pol. Econ. 262, 262 (1923) (observing that the problem of international double taxation had recently "assumed great importance" due to wartime tax increases and the growing magnitude of international business transactions).

[11] Witte, *supra* note 3, 84-85.

[12] Technically, as long as a full deduction for foreign taxes was allowed, combined (*i.e.*, U.S. and foreign) corporate tax rates would never reach 100 percent, but when the individual tax on dividends was also taken into account, rates approaching 100 percent were possible.

[13] The foreign tax credit was available unconditionally to U.S. citizens, but was only available to resident aliens who were citizens of countries granting similar benefits to U.S. citizens residing abroad. *Compare* Revenue Act of 1918, ch. 18, 40 Stat. 1057, § 222(a)(1) (1919) (credit for citizens) with Revenue Act of 1918, ch. 18, 40 Stat. 1057, § 222(a)(3) (1919) (credit for resident aliens). The foreign tax credit was not available to nonresident aliens.

The 1918 Act also originated the "indirect" or "deemed paid" foreign tax credit, which allows a domestic corporation a foreign tax credit for foreign taxes paid by foreign subsidiaries on their income when dividends are distributed to the domestic corporation by those subsidiaries. Revenue Act of 1918, § 240(c). Subsidiaries incorporated in foreign countries are not considered U.S. residents and therefore are not subject to U.S. taxes on their income earned abroad. The dividends paid to a U.S. parent, however, are income of the parent and the indirect foreign tax credit was considered necessary to relieve double taxation of that income.

responsibility for the costs of reducing the double taxation of its residents and citizens.[14] In so doing, the United States seemed to be relinquishing valuable leverage with the potential to convince other countries to forego taxing their residents on U.S.-source income. As the influential economist Edwin Seligman remarked, "the United States is making a present of the revenue to other countries."[15] As a practical matter, the foreign tax credit was not as generous as it might have appeared. Virtually all the foreign income of U.S. persons was then earned by corporations doing business abroad. Corporations incorporated in foreign countries were not treated as U.S. residents, even if owned by U.S. corporations or other U.S. residents, and were not taxed currently by the United States on their foreign-source income. Taxation did not occur in the United States until the foreign earnings were repatriated as dividends to U.S. owners.

Treasury's tax expert, T.S. Adams, who proposed the foreign tax credit to the Congress, explained the injustice he wished to correct in terms of equity:

> There is something in the legislative mind which recognizes that if one taxpayer is being taxed twice while the majority of men similarly situated are being taxed only once, by the same tax, something wrong or inequitable is being done which, other things being equal, the legislator should correct if he can.[16]

Adams pursued the enactment of the foreign tax credit because he felt that "it touched the equitable chord of sense, and because double taxation under the heavy war rates might not only cause injustice but the actual bankruptcy of the taxpayer."[17]

The foreign tax credit provoked little opposition (indeed, attracted little notice) and became law in 1919.[18] Adams attributed the enactment of the foreign tax credit to the fact that legislators are particularly sensitive to the

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[14] *See generally* T. S. Adams, *The New Revenue Act*, 108 THE NATION 316, 316 (1919).

[15] *See, e.g.*, EDWIN R.A. SELIGMAN, DOUBLE TAXATION AND INTERNATIONAL FISCAL COOPERATION 135 (1928).

[16] T. S. Adams, *International and Interstate Aspects of Double Taxation*, NAT'L TAX ASS'N PROC. 193, 198 (1929) [hereinafter "Adams"].

[17] *Id.*

[18] T.S. Adams expected his proposal to be rejected because the press of war-time financing made tax relief generally inappropriate in 1918:

> In the midst of the war, when the financial burden upon the United States was greater than it had ever been, I proposed to the Congress that we should recognize the equities…by including in the federal income tax the so-called credit for foreign taxes paid.…I had no notion…that it would ever receive serious consideration.

charge of double taxation.[19] He later observed, "In my experience with legislative bodies I have found that you can accomplish more for equity and justice in taxation in the name of eliminating or preventing double taxation, than with any other slogan or appeal."[20]

Double taxation was viewed not as an issue of economic efficiency, but as a matter of invidious discrimination, and Adams regarded taxation by the country of residence as the cause of this discrimination: "More double taxation of the unjust variety is inflicted upon the taxpayer by his own government than by foreign governments."[21] He elaborated:

> Every state insists upon taxing the non-resident alien who derives income from sources within that country, and rightly so, at least inevitably so. Now, then, in due course of time, citizens of the home state inevitably invest abroad and derive income from foreign sources. The average state refuses to acknowledge in this situation the right of its own citizens to a proper exemption on income derived from foreign sources…[I]t refuses to recognize when one of its own citizens or nationals gets income from a foreign source that he inevitably will be taxed abroad.[22]

Given the predictability and appropriateness of taxation at source, if the country of residence levied an additional tax on foreign-source income, it would discriminate against residents that earned their income abroad.

Congress was particularly concerned with the burden of double taxation and the need to relieve it in light of wartime tax rates, but there also was growing recognition of a need to encourage private investment by Americans in Europe. Certain members of Congress depicted the foreign tax credit "as a method to encourage foreign trade and to prevent revenue loss through incorporation of foreign subsidiaries or expatriation."[23] Exporting was

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[19] Adams, *supra* note 16, 197, 198.

[20] *Id.*, 197.

[21] *Id.*

[22] *Id.*, 197-98.

[23] Roswell Magill & William C. Schaab, *American Taxation of Income Earned Abroad*, 13 TAX L. REV. 115-118 (1958) [hereinafter "Magill & Schaab"].

important to the country's economic well-being and required support from the government.[24] Relief from double taxation constituted just such support. Mitchell Carroll, an international tax lawyer who served as Adams' assistant during the 1920s, characterized the foreign tax credit as follows:

> The American credit system is ideal for a wealthy country that desires to encourage the expansion of its foreign trade, and is willing to afford relief from double taxation to its own citizens or residents…The United States says, in effect, to its citizens—go abroad and trade. If you have to pay tax on your earnings in foreign countries, show me your tax bill and I will give you relief.…[25]

Many U.S. leaders believed U.S. prosperity depended in large measure on the competitiveness of U.S. business abroad.[26] President Harding declared, "[W]e protect American business at home, and we aid and protect it abroad."[27]

[24] In the 1920s, the locus of this support was Herbert Hoover's Department of Commerce. The Commerce Department took an active interest in international tax issues. Commerce played a role in the decision to send Adams to London and Geneva as the U.S. representative on the League of Nations' Committee of Experts, *Adams Choice Here for Parley Abroad to Ease Trade Tax*, N.Y. J. of Commerce (December 28, 1926) (reproduced from National Archives), and dispatched its own foreign tax officer toact as Adams' assistant at the meetings, Herndon, *supra* note 5, 65.

While Commerce's preference may have been for exporting goods, and not capital, the international balance of payments was such that the export of goods after World War I depended on the export of capital. The United States was perceived to have a surplus of financial capital, Joseph Brandes, Herbert Hoover and Economic Diplomacy 160, 163 (1962) [hereinafter "Brandes"]. Moreover, Europe's high tariff barriers made the export of finished goods difficult and U.S. firms found it increasingly profitable to invest in manufacturing subsidiaries abroad, the sales of which were free from tariffs, rather than to sell wholly U.S.-made goods. Frank A. Southard, American Industry in Europe 115-119 (1931) [hereinafter "Southard"]. In sum, there was little sense in systematically treating the export of capital less favorably than the export of goods, and, in fact, Commerce generally encouraged portfolio investment abroad. Brandes, *supra*, 163.

While the U.S. government encouraged the export of capital, the import of capital seems to have been somewhat less of a priority. This is understandable given the dearth of capital in post-war Europe. Indeed, much of the meager post-war investment by European firms in the United States was funded with U.S. capital. Southard, *supra*, 200.

[25] Carroll, *supra* note 8, 28-29. Congress also tended to view the foreign tax credit as an export-enhancing device, an attribute of the foreign tax credit that was discussed when it was originally adopted in 1918 and that helped preserve the foreign tax credit against an assault by the House Ways and Means Committee in 1933, Magill & Schaab, *supra* note 23, 188 and 120.

[26] Brandes, *supra* note 24, 171. *See also Id.*, 12 ("Throughout Hoover's term as Secretary [1921-1928], the Department of Commerce spared no effort in acting on the policy that exports were a key to business stability and thus to American prosperity.").

[27] Warren G. Harding, *Less Government in Business and More Business in Government*, 41 The World's Work 25 (1920), *quoted in* Brandes, *supra* note 24, 15.

By the end of 1918, the United States had an additional reason to favor relief for Americans investing abroad: a variety of U.S. economic and diplomatic interests required a substantial amount of U.S. capital to be channeled into rebuilding post-war Europe. Allied governments owed the United States $11 billion for wartime loans; Europe needed access to U.S. dollars to pay off this debt.[28] Europe also needed U.S. dollars to purchase U.S. exports—a central goal of U.S. economic policy.[29] Given U.S. antipathy to imports and its high tariffs, it was difficult for Europeans to sell goods to the United States. Moreover, the World War I devastation of Europe's human, physical, and financial capital made serious competition by Europeans in U.S. markets unlikely. If dollars could not be raised through sales, another possibility was loan forgiveness or other public financing of European recovery by the U.S. government. However, domestic politics in the United States were very different after World War I from what they were after World War II. Americans wanted smaller government, lower taxes, and fewer international entanglements. Americans would not tolerate loan forgiveness, much less a kind of Marshall Plan, to aid Europe at a time when the U.S. government was itself sagging beneath what it considered an enormous wartime debt.[30] If Europe

[28] *See* Brandes, *supra* note 24, 171. For a general discussion of the history of the war debts in the 1920s, *see id.*, 170-180. The Allies objected vociferously to U.S. insistence on full repayment, tagging the United States with the label "Uncle Shylock." *Id.*, 170. After the war, the United States gave a brief respite to its allies, but ultimately applied economic sanctions to force its debtors to enter into repayment agreements, which most did between 1923 and 1926. *Id.*, 173-179.

Ultimately, the debt issue was about more than just inter-allied relations: U.S. insistence on debt repayment forced the Allies to press Germany for war reparations, the bill for which amounted to $33 billion. *Id.*, 180. The U.S. government perceived that the rebuilding of Germany was vital to the future prospects for peace in Europe, and, in 1924, to relieve the financial pressures imposed by reparations, advanced a substantial loan to Germany and encouraged private U.S. investment in the German recovery *Id.*, 182-183.

[29] U.S. interest in exporting to Europe did not abate even during wartime. In April 1918, for instance, Congress passed the Webb-Pomerene Bill, which permitted U.S. businesses to join together for exporting purposes, notwithstanding antitrust laws. The purpose of this bill was to give U.S. exporters greater leverage in negotiating with cartels of European buyers. MIRA WILKINS, THE MATURING OF MULTINATIONAL ENTERPRISE: AMERICAN BUSINESS ABROAD FROM 1914 TO 1970, 49-50 (1974) [hereinafter "Wilkins"].

Historically, Europe was the largest market for U.S. exports, taking 64 percent of the total in 1914. SIDNEY RATNER ET AL., THE EVOLUTION OF THE AMERICAN ECONOMY, 386-87 (1979). Before World War I, the United States had been a net exporter of goods and services for four decades, but a net importer of capital. *Id.*, 385. Although the book value of U.S. investments abroad increased from $94 billion to $478 billion between 1897 and 1914, it took World War I to transform the United States into a net exporter of capital, Wilkins, *supra*, 17-18 and 30. Exports of capital would need to remain high to fund the continued purchase of U.S. goods in Europe, on which the U.S. economy had increasingly come to rely. The total value of U.S. exports had more than doubled between 1914 and 1916. Harry N. Scheiber, *World War I as Entrepreneurial Opportunity: Willard Straight and the American International Corporation*, 1969 POL. SCI. Q. 486, 497.

During the postwar era, it was a commonplace that U.S. capital would need to be sent abroad to maintain and expand the sale of U.S. goods in other countries: "the American banker and the American salesman must go abroad hand in hand." *Id.*, 509. Indeed, even during wartime, the authorization of loans to European nations was largely motivated by the desire to help U.S. export trade. *Id.*, 494.

[30] Paul P. Abrahams, *American Bankers and the Economic Tactics of Peace: 1919*, 56 J. AM. HIST. 572, 573, 583 (1969) [HEREINAFTER "ABRAHAMS"].

was going to obtain the dollars necessary for the repayment of its debts, the purchase of U.S. exports and the economic stability necessary for peace, the source would have to be private investment.[31]

The foreign tax credit recognizes the primacy of the claim of the country where the income was earned—the source country—over the claim of the country the residents of which supplied the investment capital—the residence country. The United States did not, in 1918 or thereafter, and will not, forego taxation of business income earned in the United States regardless of the residence of the business' owners.[32] Adams stated the case for taxation of business income at source: "Business competes with business, not owners with owners,"[33] adding:

> Income must to some extent be taxed where it is earned, at rates and by methods determined by the conditions under which it is earned—not by the conditions under which it is spent.…[C]orporations and other business units derive benefits and compete with one another as units, in the jurisdictions in which they do business.[34]

[31] Observing these imperatives, Commerce Secretary Hoover urged greater investment in Europe in a speech to the American Bankers' Association, arguing that such investment would raise "the capacity of foreign people to purchase American goods and to repay obligations to the United States." Brandes, *supra* note 24, 152 (quoting Hoover's speech on December 10, 1920). But, setting out important qualifications, Hoover also insisted that loans be extended through private channels and that they be carefully tailored to achieve productive purposes. *Id.*, 152.

Connecting these imperatives with international tax policy, George May, a U.S. businessman who worked with Adams in the International Chamber of Commerce's double taxation initiative, argued that the United States was compelled to relieve double taxation because, "Our own country could hardly maintain its policies of restriction of imports through high tariffs, exportation of surplus products, collection of foreign government debts and the building up of a merchant marine, without making foreign investments to balance international accounts." George O. May, *Double Taxation*, 5 FOREIGN AFFAIRS 69, 69 (1926) [hereinafter "May"].

The United States undertook a number of additional initiatives in 1918-1919 to encourage investment abroad. Perhaps the most noteworthy, apart from the foreign tax credit, was Congress' passing of the Edge Act in late 1919, which promoted the development of federally-chartered banking enterprises designed to channel private domestic capital to European reconstruction.

For a full description and history of the Edge Act, see Abrahams, *supra* note 30, 577-583. Abrahams argues that the Edge Act was a response to the tension between U.S. trade and fiscal policies after World War I: "As the Americans saw it, the problem was to keep responsibility for the war-debt payments in Europe and at the same time give the Europeans enough financial breathing space to reconstruct their economy, restore the trade network, and earn enough dollars to pay their debts and buy American exports." *Id.*, 575-578.

[32] T. S. Adams, *Fundamental Problems of Federal Income Taxation*, 8 QUARTERLY J. OF ECON. 527, 542 (1921) [hereinafter "Fundamental Problems"] ("If the members of a partnership engaged in business in Detroit all live in Canada, and the partnership competes with business concerns the owners of which live in Detroit, our people will not consent to exempt the Canadians while the owners who live in the United States are taxed on their entire income or expenditures…")

[33] *Id.*

[34] *Id.*, 543.

In enacting the foreign tax credit, Congress decided that the United States, as the country of residence, should defer to the country of source to prevent double taxation, but Congress did not reject residence-based taxation altogether. Congress viewed residence as a backstop to source-based taxation, which is why it adopted a credit for foreign-source taxes paid abroad, rather than an exemption for foreign-source income.

Given current policy debates, it is notable that the move away from a deduction for foreign taxes to a foreign tax credit in the 1918 Act did not reflect any political decision to shift U.S. tax policy in favor of "worldwide economic efficiency" or "capital export neutrality."[35] The Sixteenth Amendment permitting a federal income tax had recently been sold to the American people on fairness grounds and, in 1918, arguments grounded in tax equity were much more important politically than the idea of promoting more economically efficient investments. The enactment of the foreign tax credit was intended to ensure that the tax burden on investment and business income did not become too high ("double taxation") simply because the income was earned abroad rather than in the United States. The foreign tax credit was also advanced to ensure that the foreign-source income of individuals and businesses should not escape taxation altogether and to promote U.S. investments abroad.[36]

III. 1921 Act—Limiting the Foreign Tax Credit

With the foreign tax credit, Congress put into place the centerpiece of a U.S. international tax regime that persists to this day. The United States still taxes nonresidents on U.S.-source income.[37] It taxes U.S. residents and citizens on their income wherever earned, but allows them to offset their U.S. tax liability with a credit for income taxes paid abroad. The Revenue Act of 1921

[35] "Capital export neutrality" is a term used to describe a situation in which tax considerations will play no part in influencing a decision to invest in another country.

[36] Graetz & O'Hear, *supra* note 1, 1098-1099.

[37] Foreign enterprises doing business in the United States were taxed on their net income from U.S. sources. *See, e.g.*, Act of August 5, 1909, Ch. 6, 36 Stat. 11 (taxing income of foreign corporations from "business transacted and capital invested within the United States"). *See also* Revenue Act of 1918, § 213 (e).

To facilitate the collection of taxes from nonresident aliens, the 1918 Act required U.S. payors of fixed or determinable annual or periodic income to withhold a percentage of the income. Revenue Act of 1918, § 221. Such withholding taxes have become another fixture of U.S. international tax policy, although currently, unlike under the 1918 and 1921 Acts, these withholding taxes are final taxes, and not subject to offsetting deductions and credits.

retained this basic structure, but significantly refined the foreign tax credit mechanism.

The most important of these refinements was a limitation on the foreign tax credit. As originally enacted, foreign tax credits could be used to offset up to the full amount of any U.S. "income, war profits and excess-profits taxes" owed by a U.S. taxpayer. Thus, a U.S. resident or citizen with substantial investments abroad, particularly if made in a high-tax country or countries, could eliminate his entire U.S. tax liability. With the high U.S. tax rates in effect in 1918 and 1919, the practical ability of the foreign tax credit to eradicate U.S. tax liability was not readily apparent. By 1921, however, U.S. rates had fallen considerably and were about to be reduced further,[38] but European countries still maintained their higher rates. In 1921, for example, the "normal tax" (*i.e.*, the base rate applied to the lowest income categories) was 10 percent in the United States, but 30 percent in the United Kingdom.[39] Under such circumstances, a U.S. resident or citizen investing in the United Kingdom might be able to eliminate his entire U.S. tax liability with foreign tax credits even though most of his income was from U.S. sources. Contemporary critics characterized the unlimited foreign tax credit as an instance of unjustified "prodigality" on the part of the U.S. government.[40]

Speaking once again for the Treasury Department, Adams justified a limitation on the foreign tax credit to the Senate Finance Committee as follows:

> [The unlimited foreign tax credit] is subject to this rather grave abuse: If the foreign taxes are higher than our rate of taxes, that credit may wipe out taxes which fairly belong to this country.…[W]e know of instances where big corporations whose income was derived largely from this country have had their tax wiped out, so far as this country is concerned, because the English tax rates are three times as high as ours.[41]

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[38] *See* Witte, *supra* note 3, 88 (observing that maximum rates on individuals fell from a war-time high of 77 percent to 24 percent by the end of the 1920s).

[39] *Internal Revenue: Hearings on H.R. 8245 Before the Committee on Finance of the United States Senate*, 67th Cong., 1st Sess. (1921), *reprinted in* 95A Internal Revenue Acts of the United States 1909-1950, Legislative Histories, Laws, and Administrative Documents (Bernard D. Reams, Jr., ed. 1979) [hereinafter "1921 Hearings"].

[40] May, *supra* note 31, 69, 75.

[41] *Id.*, 73-74.

Specifically, Adams requested, and Congress enacted, an "overall limitation" on the foreign tax credit: the amount of foreign tax credit available to any taxpayer was limited to a proportion of the taxpayer's overall U.S. tax liability equal to the proportion of the taxpayer's global income derived from foreign sources.[42] For instance, a U.S. resident or citizen obtaining 10 percent of his worldwide income from foreign sources could use the foreign tax credit to offset a maximum of 10 percent of his total U.S. tax liability on his worldwide income. Taxpayers would thus have to bear an increased tax burden if their investments were in foreign countries with average tax rates higher than those of the United States. To the Senate Finance Committee, the case for such a limitation was so strong that there was no need even to discuss the proposal.[43] The repeal of the U.S. excess profits tax in 1921 made the need for the limitation even more compelling.

The fundamental purpose of the 1921 foreign tax credit limitation was to protect the ability of the United States to collect tax on U.S.-source income, but the limitation on the foreign tax credit also affects the investment decisions of U.S. residents. Generally, under such a limitation, if a foreign country's tax rate is higher than the U.S. rate, a U.S. investor will prefer a domestic investment to a foreign investment with an identical pre-tax rate of return. However, the limitation's averaging of foreign taxes of high-tax and low-tax countries could make investments in low-tax countries attractive to a U.S. investor that already has made some foreign investments (enabling low-tax foreign countries' taxes to average high-tax foreign countries' taxes, thus making full offsetting of U.S. tax possible). The same feature could make a similar investor indifferent as to investments in high-tax countries (because, with investments in low-tax countries, the limitation might operate to disallow credits for the high-tax countries' taxes). The limitation enacted in 1921 clearly eliminated the pure neutrality as between foreign and domestic investments with the same pre-tax rates of returns that had existed under the unlimited earlier version of the foreign tax credit. The policy aspects of the limitation are taken up in Chapter 6.

The method for determining the limitation on foreign tax credits has taken a variety of forms over the years, having been computed based on a taxpayer's overall foreign-source income when first enacted in 1921. In 1932, as part of a general revenue increase, Congress revised the limitation so that taxpayers were required to use the lesser of an overall or a per-country amount.[44] In 1954, the overall limitation was repealed, leaving only a per-

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[42] The foreign tax credit limitation appears at Revenue Act of 1921, ch. 136, 42 Stat. 227, § 222(a)(5) (1921).

[43] May, *supra* note 31, 74.

[44] Revenue Act of 1932, § 131 (b).

country limitation.[45] In 1960, taxpayers were given the option of using an overall or a per-country limitation.[46] In 1976, the per-country limitation was repealed and the law returned to its 1921 shape.[47] There it rested until 1986, when the current system, which categorizes various types of income into "baskets" for purposes of calculating the foreign tax credit limitation, came into effect.[48] As described in Chapters 2–4 of this Report, when the limitation has been changed, Congress has often reiterated its original concern with protecting the U.S. tax base on U.S.-source income from erosion.

IV. Development of League of Nations' Model Tax Treaties

In the discussions leading up to the League of Nations' model tax treaties of 1927 and 1928, the U.S. representatives were principally concerned with the taxation of business income. While the U.S. representatives wished both to improve the competitiveness of U.S. businesses and to reduce the revenue cost of the foreign tax credit, their primary concern was to rationalize source-based taxation to preclude taxation by all conceivable sources.[49] The U.S. preference for source-based taxation did not conflict with its interest in reducing the taxes levied by other countries on U.S. businesses. Apart from eliminating a proposed distinction between personal and impersonal taxes that did not well fit the U.S. tax system and that, in the view of the U.S. delegation, threatened the ability of the United States to impose tax on the U.S.-source income of nonresidents, this seems to have been the chief goal of the U.S. delegation. Mitchell Carroll described the growing problem facing U.S. businesses abroad:

> After World War I when governments were in dire need of revenue to rebuild their economies, they began to try to tax the earnings of the visiting businessman and the profits of the foreign company on goods sold through him. Canada even tried to tax a United States

[45] I.R.C. § 904 (1954).

[46] I.R.C. § 904 (b) (1960).

[47] I.R.C. § 904 (1976).

[48] I.R.C. § 904(d) (1986). Other "refinements" have also been made, principally in an effort to ensure that the credit limitation operates to protect U.S. taxation of U.S.-source income, as the 1921 Act had originally intended. *See, e.g.*, Treasury Reg.§ 1.861-8 (allocating interest deductions and research and development costs).

[49] Carroll, *supra* note 8, 693-694.

> firm on profits from advertising its wares and receiving mail orders from customers in its territory.
>
> In the early 1920's, the British Board of Inland Revenue sought to impose liability…[on] sales through a local commission agent…[e]ven if the nonresident and his British intermediary took pains to conclude the contract abroad.[50]

Adams had made clear that some of the reforms he presented in the 1921 Act had the competitiveness of U.S. businesses in mind. He carried similar concerns with him into his tax treaty work:

> [Legislation authorizing U.S. negotiation of tax treaties] will enable the businessmen of this country to compete on somewhat fairer terms with the businessmen of those foreign countries which have the benefit of conventions or treaties of this kind protecting them from the burdens of international double taxation.[51]

In the face of the U.S. concern with expanding jurisdiction over business income, the League of Nations ultimately adopted the "permanent establishment" safeguard. As a result, only a country in which a permanent establishment of a business enterprise was located could legitimately levy source-based taxes on the income of the enterprise.[52] The United States relieved U.S. businesses of much potential foreign

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[50] *Id.*, 700. A business representative described the problem as follows:

> Any plan which seeks to avoid double taxation by subjecting business income to taxation only in the country where made…necessarily raises an issue as to where income is earned. Further, it would be quite possible to have an international correlation of income tax laws such as would theoretically eliminate double taxation and yet the same would continue to exist under cover because of conflicting and overlapping theories of allocation by which two or more countries might consider the same income earned within their borders.

Letter from Elliott, Law Department of International Harvester Company, to T. S. Adams 1 (May 8, 1922) (available in T. S. Adams Papers, Yale University, Box 12).

[51] Adams, *supra* note 16, 194. Adams' associate, Herndon, further observed that such concern over U.S. businesses being left out of favorable foreign tax treaties was one of the major reasons the United States decided to participate in the model treaty effort in the first place. Herndon, *supra* note 5, 64.

[52] Permanent establishments were defined as follows: "The real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a *bona fide* agent of independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country." Herndon, *supra* note 5, 195 (quoting Draft Convention 1a, art. 5).

taxation with the permanent establishment rule, while preserving the primacy of source-based taxation.[53]

V. Conclusion

Analysts of the U.S. system of taxing international income have often claimed an unbroken line of U.S. policy preference for residence-based over source-based taxation. The early history of the foreign tax credit proves such claims to be mistaken. To the contrary, Congress regarded the claims of the country of source as having precedence over the claims of the country of residence, at least in business taxation.[54]

The goals of Congress in enacting the foreign tax credit in 1918 and its limitation in 1921, as well as of U.S. participation in the formative League of Nations tax treaty effort, were to achieve fair and nondiscriminatory taxation, to promote exports of U.S. goods and capital, to protect U.S. taxation of U.S.-source income, to adopt administrable taxes, to eliminate certain tax avoidance devices, and to clarify and make more uniform the international rules for determining the sources of various categories of income. This work entailed a combination of principled idealism, national self-interest, and political and administrative practicality.

It was not any particular economic theory, but rather concerns with the unfairness of double taxation, coupled with a preference for the source-based taxation of business income (based on the view that the countries where such income is earned both are entitled to a share of that income and will claim such a share), that shaped U.S. international tax policy.

[53] *See* Graetz & O'Hear, *supra* note 1, 1088-1089.

[54] Adams was also clear in his view that "[d]ouble taxation cannot be brought within reasonable limits by constitutional restraints or by theories of jurisdiction resting on the essential nature of particular taxes." Adams, *supra* note 3, at 524. He rejected the potential usefulness of any grand theory of what he called "broad dogmatic generalization" in making international tax law. Instead, he viewed the economic self-interest of nations and private actors as the controlling political force. Adams' policy judgments were also often driven by concerns for the enforcement and collection of taxes. *See* Graetz & O'Hear, *supra* note 1, 1097-1102.

Chapter 2

Overview of Foreign Tax Credit Limitation Rules and Historical Purpose of Foreign Tax Credit Limitation

I. Introduction

As noted in the previous chapter, policy concerns that were important in the initial adoption of the foreign tax credit were double taxation and the competitiveness of U.S. companies and exports, factors acknowledged even by critics of the credit.[1] Protection of the U.S.-source income tax base was the original concern of the drafters of the foreign tax credit limitation and Congress has regularly invoked this concern in rationalizing later limitation modifications. Concerns about fair treatment of similarly situated taxpayers also played a role in the refinement of the limitation rules, at least in the early decades of their existence. Since enactment, the foreign tax credit and the limitation have been modified many times. A number of policies and concerns have prompted these changes, with many changes substantially amending the balance struck in previous formulations.

It may be possible to reduce the history of the foreign tax credit to a few broad themes. First, the rules have become much more complex and, at the same time, less certain over time. Second, as tax rates and budget needs have

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[1] *See* Remarks of Sen. Albert Gore, Sr., Minority Views of H.R. 10087, S. Rep. No. 1393, 86th Cong., 2nd Sess. 886 (1960).

increased over time, revenue goals and constraints have sometimes molded the features of the foreign tax credit rules at the expense of sound tax policy, especially in the 1980s when many features of the current system were adopted. Third, the foreign tax credit limitation has been in existence for nearly 80 years, but no consensus has ever been reached on a theoretically "correct" limitation formulation. Fourth, some redundancy has crept into the foreign tax credit rules in recent years.

Congressional and IRS/Treasury drafters have not always focused on the compliance and administrative costs of new regimes and refinements, and have been unable fully to anticipate these systems costs. The foreign tax credit limitation rules, whether purposely or not, strike a balance between the pursuit of various tax and non-tax legislative goals, on the one hand, and administrability and certainty of result, on the other. While some complex rules are favorable to taxpayers in that they reduce the tax bill, the current balance, in our view, tilts too far toward pursuit of tax and non-tax legislative goals and does not adequately consider compliance, administrative, and uncertainty costs.

Chapters 2 through 4 describe certain developments in the history of the foreign tax credit. One purpose of these chapters is to review Congress's reasons for enacting some of the key provisions to increase understanding of how the credit rules evolved to their current incarnation. This review also facilitates our evaluation of whether tax policymakers were on sound tax and economic policy grounds at the time they adopted the provisions, and whether those policy grounds are sound today in light of changing economic conditions and tax systems worldwide.

Following a brief overview of the foreign tax credit limitation rules, Chapter 2 analyzes the historical purpose of the foreign tax credit limitation, which has had various formulations over its 80-year life. The basic purpose of the foreign tax credit limitation—preserving the U.S. tax on U.S.-source income—has always been clear. To fulfill this purpose, a single or "overall" limitation is all that is required, provided the source-of-income and expense allocation and apportionment rules are well designed.

The rationales advanced for the overall and other (*i.e.*, per-country, separate, and special) formulations of the limitation have been diverse and sometimes contradictory. Congress has addressed a variety of concerns in developing the limitations, including fairness, preserving the U.S. and foreign-source income tax bases, facilitating international operations of U.S. companies, capital allocation between the United States and overseas jurisdictions, revenue needs, foreign policy, and coordination between U.S. tax treaties and the Internal Revenue Code.

II. Overview of Foreign Tax Credit Limitation and Related Rules

As originally adopted, the foreign tax credit was not subject to a foreign tax credit limitation. However, by 1921, U.S. tax rates had fallen without a corresponding reduction in foreign tax rates, [2] and it became apparent that a U.S. taxpayer's entire U.S. tax liability could be eliminated by higher foreign income taxes. Treasury regarded this as a grave abuse and the Senate Finance Committee approved, without discussion, the imposition of a foreign tax credit limitation. This limitation permitted the foreign tax credit to reduce the U.S. tax on foreign-source income, but not the U.S. tax on U.S.-source income,[3] and preserved the United States' ability to collect tax on that U.S.-source income, *i.e.*, to avoid ceding to foreign countries the primary right to tax such income.[4] A later-enacted feature of the foreign tax credit rules that helps preserve the United States' ability to tax U.S.-source income is the overall foreign loss (OFL) recapture rule in section 904(f) of the Code. Under this rule, U.S.-source income offset by a foreign loss in a given year is restored in later years.

For the limitation rules to operate, it must first be determined what is U.S.-source income and what is foreign-source income. This determination, in turn, relies on two sets of rules: the source rules, found in sections 861-865 of the Code, for classifying gross income as from U.S. or foreign sources (or as partly from each), and the expense allocation and apportionment rules in sections 861-864 of the Code, for dividing expenses between gross foreign-source and gross U.S.-source income.

The source and expense allocation and apportionment rules have been modified frequently, the revisions often generating considerable tax policy debate. Some source rules provide foreign sourcing for income that may bear low or no foreign tax, thereby increasing the potential for averaging;[5] illustrative in this regard are the source rule for royalties for technology used overseas and the sales component of the inventory property sales source rule. Other source rules, such as the U.S.-source treatment of U.S.-performed

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[2] *See* Michael J. Graetz & Michael O'Hear, *The Original Intent of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997).

[3] *Id.*, 1055.

[4] *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 99th Cong., 2d Sess.854 (1987) [hereinafter "1986 Bluebook"].

[5] Some changes in the foreign tax credit limitation have been tied to concerns regarding what is often referred to as "averaging" of foreign tax credits. For example, if a taxpayer is operating in both Country A and Country B, and Country B's tax rate is lower than the U.S. rate, then, assuming the "overall" version of the foreign tax credit limitation applies, any Country A taxes in excess of the U.S. tax on Country A income can be used to reduce or eliminate the U.S. tax on the low-taxed Country B foreign-source income.

technical services income taxed by foreign countries, can produce double taxation. With regard to expense allocation and apportionment, the overhaul of the interest expense apportionment rules in 1986, in particular, had major compliance and other consequences for the computation of the foreign tax credit that Congress may not fully have anticipated.

The current separate foreign tax credit limitation regime was created largely by the Tax Reform Act of 1986. In 1986, Congress frankly acknowledged that the new separate limitations contained in the tax reform bill were aimed in part at increasing taxes on foreign-source income in light of the Act's estimated tax increases on U.S.-source income elsewhere in the legislation.[6] Congress also expressed concern that "the incentive to choose foreign over U.S. investment would be more pronounced in the future as a result of the [1986] Act's tax rate reductions: lower U.S. taxes (relative to foreign tax rates) cause many taxpayers to have more excess credits and more taxpayers to operate in excess credit positions."[7] As discussed in Chapter 6 of this report, this premise of the 1986 Act separate limitations has been substantially eroded in recent years by worldwide tax rate reductions.

Any set of limitation rules (short of a "per-item" limitation) necessarily strikes a balance between compliance, administrability, and certainty goals, on the one hand, and revenue, capital allocation and other policy goals, on the other. The current limitation rules are the most complicated in the history of the foreign tax credit and strike that balance in a manner favoring the latter goals over the former.

We turn now to an examination of the original concerns of the foreign tax credit limitation and the enduring nature of those concerns over the limitation's long history.

[6] Staff of the Joint Committee on Taxation, *supra* note 4, 862.

[7] *Id.*

III. Historical Purpose of Foreign Tax Credit Limitation

The legislative record shows that the foreign tax credit limitation was originally created with a basic purpose: to protect the U.S.-source income tax base. The drafters were also concerned, however, with fair treatment of similarly situated taxpayers in the early decades of the limitation's existence. These two concerns have never been abandoned and are reflected in some of the later amendments to the foreign tax credit limitation rules. It is primarily these amendments that are discussed in this chapter. Congressional concerns with revenue constraints, the worldwide allocation of capital, the taxation of foreign-source income, and certain other tax and non-tax legislative goals emerged fairly late in the limitation's history and are the focus of Chapters 3 and 4.

A. Introduction of Overall Limitation

Congress enacted the first limitation on the foreign tax credit in the Revenue Act of 1921.[8] The first foreign tax credit limitation effectively restricted the amount of a taxpayer's foreign tax credit in any one year to the amount of the taxpayer's pre-credit U.S. tax on its total net foreign-source income. This formulation of the limitation is generally referred to as the "overall" limitation because foreign-source income is not further subdivided; foreign taxes on one type of foreign-source income may be credited against, or averaged with, the U.S. tax on any other type of foreign-source income without further limitation.

By enacting a foreign tax credit limitation, Congress preserved primary taxing jurisdiction over income earned in the United States for the United States. At the time the limitation was adopted, the principle of capital export neutrality, *i.e.*, that tax should be a neutral factor for U.S. persons in deciding between U.S. and foreign investments, had not yet been developed.[9] No concern was expressed in 1921 about the averaging of foreign tax rates under the overall limitation. Other legislative issues that have dominated recent debate on the foreign tax credit limitation could scarcely have been imagined.

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[8] Revenue Act of 1921, §§ 222(a)(5) (individuals) and 238(a) (corporations). §§ 222 and 238 of the Revenue Act of 1921, which dealt with individual and corporate foreign tax credits, respectively, were combined into § 131 in the Revenue Act of 1928. The limitation portion of such provisions was combined in § 131(b). *See* Chapter 1.III. of this report for further discussion.

[9] The term capital export neutrality did not appear in economic literature until 1963. *See* Peggy Brewer Richman, Taxation of Foreign Investment Income, An Economic Analysis (1963).

B. Adoption of Lesser of Per-Country or Overall Limitations

The limitation rules were first modified 11 years after their enactment in the Revenue Act of 1932. That Act introduced a per-country foreign tax credit limitation, and began a pattern of revision and tinkering that continues to this day. The per-country limitation prevented foreign taxes paid to one country from reducing the U.S. tax on income earned in another foreign country. Some argued in 1932 that the foreign tax credit should be eliminated entirely because it did not achieve parity in the taxation of U.S. and foreign operations. The adoption of the per-country limitation instead reflected a compromise that addressed a stated Congressional concern regarding fair treatment of similarly situated taxpayers.[10]

Congress expressed concern in 1932 about foreign income that was not subject to tax in the foreign country in which it was earned, or that was subject to a rate of tax in that country that was lower than the U.S. rate. The House Ways and Means Committee Report stated that the overall limitation "gives preferential treatment to some taxpayers deriving income from more than one foreign country," and illustrated the point using the following example.[11]

	Taxpayer A		Taxpayer B		Taxpayer C	
	Income	Foreign taxes paid	Income	Foreign taxes paid	Income	Foreign taxes paid
From United Kingdom	1,000	250	1,000	250	—	—
From Argentina	—	—	1,000	-0-	1,000	-0-
From United States	2,000	—	1,000	—	2,000	—
Total income	3,000		3,000		3,000	
U.S. tax (12%) before credit	360		360		360	
Proportion of foreign income to total income	1/3		2/3		—	
Credit for foreign taxes	120		240		None	

[10] C. McClure & H. Bouma, *The Taxation of Foreign Income From 1909 to 1989: How a Tilted Playing Field Developed*, 43 TAX NOTES 1379, 1382 (1989) [hereinafter "McClure & Bouma"].

[11] H.R. REP. No. 708, 72d Cong., 1st Sess. 23-24 (1932).

The report noted that the United States was able to collect full U.S. tax from Taxpayer C on its Argentine income, while the United States did not collect any U.S. tax from Taxpayer B on an identical amount of Argentine income because Taxpayer B was able to use taxes paid to the United Kingdom to eliminate such U.S. tax.[12] Further, although Taxpayer A and Taxpayer B paid the same amount of tax to the United Kingdom and had the same amount of excess foreign tax credits after crediting those taxes against the U.S. tax on the income from the United Kingdom, Taxpayer B was able further to reduce its U.S. tax liability by its $120 excess foreign tax credit while Taxpayer A was not able to reduce its U.S. tax liability by its $120 excess foreign tax credit.[13]

The issue Congress focused on in the 1932 legislative history, then, was fairness, that is, comparable treatment of similarly situated taxpayers. Economic analysis had not yet moved to the stage of evaluating incentives to invest "at the margin" in one country or another.

By denying taxpayers the ability to use taxes from one foreign country to offset the U.S. tax on income from other foreign countries, Congress asserted the primacy of residual U.S. taxing jurisdiction over income that was not subject to tax by the foreign country in which the income was earned or that was subject to a lower rate of tax in that country than in the United States.

The 1932 Act did not substitute the per-country limitation for the overall limitation, but rather provided that taxpayers would receive the lesser of the foreign tax credit allowed under the per-country limitation or the foreign tax credit allowed under the overall limitation. The legislative history is silent on the purpose of retaining the overall limitation. The practical effect of retaining the overall limitation was that a foreign loss in one foreign country was allocated against foreign-source income in other foreign countries, rather than against U.S.-source income, thus reducing the amount of foreign taxes that could be credited. The retention of the overall limitation was possibly an early manifestation of Congressional concern regarding the adverse effect of foreign losses on the collection of U.S. tax on U.S.-source income under a per-country limitation. This concern ties conceptually to the drafters' original purpose in adopting a foreign tax credit limitation in 1921, *i.e.*, to protect the U.S. tax on U.S.-source income, since allocation of foreign losses again U.S.-source income may reduce the U.S. tax on that income.

[12] *Id.* ("[a]lthough B and C have each received $1,000 income from Argentina free of any tax, B, in effect pays no tax to the United States upon this income, while C pays the full United States tax thereon").

[13] *Id.* ("Thus B, who has paid no more foreign tax than A, is permitted to take twice as great a credit as A.").

C. Choice between Per-Country and Overall Limitations Allowed

As a result of legislative amendments in 1960, taxpayers generally could choose (until 1976) between the overall and per-country limitations. Technically, a taxpayer could elect the overall limitation in lieu of the per-country limitation. Once made, however, the election was irrevocable unless the IRS consented to revocation.[14] The legislative history of the 1960 Act explained the election as follows:

> These two limitations represent basically different concepts of the relationship between domestic and foreign income. The overall limitation in effect treats the taxpayer's income as being divisible into two parts, domestic and foreign. Thus, under this limitation a foreign tax credit is allowed for any foreign income taxes so long as these taxes do not represent more than the U.S. tax rate applied to the taxpayer's total foreign income. The per country limitation, on the other hand, treats the taxpayer's income as being divisible into many parts, his domestic income and his income from each foreign country, and applies the limitation separately to each.
>
> In most cases, American firms operating abroad think of their foreign business as a single operation and in fact it is understood that many of them set up their organizations on this basis. It appears appropriate in such cases to permit the taxpayer to treat his domestic business as one operation and all of his foreign business as another and to average together the high and low taxes of the various countries in which he may be operating by using the overall limitation.
>
> In addition, making the overall limitation generally available for foreign operations only provides treatment that is already available in the case of the so-called foreign base corporation, or foreign subsidiary serving as a holding company for subsidiaries carrying on active business enterprises. In the case of the foreign base corporation the Treasury regulations provide

[14] P.L. 86-780, § 1(a).

> that the taxes paid by its subsidiaries are to be treated as if they were paid to the foreign country where the foreign base company is incorporated, and thus aggregated for purposes of applying the limitation.
>
> On the other hand it is also recognized that in some cases taxpayers may think of their businesses in various foreign countries as separate ventures. This, of course, is especially likely when a company begins in a different foreign country a business which is risky and which is likely to result in losses at least for an initial period of years. In such cases, the company is more likely to think of such a business as being separate and apart from its other more stable operations in other foreign countries. It seems appropriate in such cases to permit taxpayers to use the per country limitations, thus for tax purposes treating each as a separate operation.[15]

As can be seen from the legislative history just quoted, Congress in 1960 expressly endorsed the averaging of high and low taxes of different foreign countries under the overall limitation, a concept that seems to have been less favored in recent enactments. The House and Senate committee reports went on to note:

> Congress in 1954 concluded that it was inappropriate for both of these limitations to be applied in determining the foreign taxes allowable as a credit and at that time repealed the so-called overall limitation. The report of your committee at that time stated as the reason for this action:
>
> As a practical matter…the overall limitation is operative only when a taxpayer earns income in one foreign country and incurs a loss in another. The effect of the limitation is unfortunate because it discourages a company operating profitably in one foreign country from going into another country where it may expect to operate at a loss for a few years. Consequently, your committee has removed the overall limitation.

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[15] H.R. Rep. No. 1358, 86th Cong., 2d Sess. 865 (1960); S. Rep. No. 1393, 86th Cong., 2d Sess. 874 (1960).

> While the per country limitation may be preferable to taxpayers where they are operating at a profit in one foreign country and at a loss in another, more frequently taxpayers find themselves in situations where averaging out the high and low taxes of different foreign countries in which they operate would be more advantageous.[16]

The regime adopted in 1960 afforded taxpayers maximum flexibility. While consent to revoke the overall limitation had to be obtained from the Treasury Department, the Senate Finance Committee received assurances from Treasury that it would be reasonable in exercising this authority.[17] The overall limitation expressly covered even high seas income, which typically bore no foreign tax.[18]

The 1960 legislative history records a theme Congress returned to in 1986, that is, because U.S. firms often consider their foreign operations to be a single operation, it seems appropriate generally to allow them to average high and low foreign taxes using the overall limitation. The Senate Report on the 1986 Act noted, for example, that, "In general, the committee believes that the overall limitation is consistent with the integrated nature of U.S. multinational operations abroad. The committee believes that the averaging of foreign tax rates generally should continue to be allowed. However the committee recognizes that, in limited situations, averaging should not be permitted when averaging would distort the foreign tax credit limitation."[19]

In her seminal 1961 book, *The Foreign Tax Credit*, Elisabeth Owens wrote in favor of the overall limitation.[20] Despite the numerous separate limitations now included in the law, the overall limitation is dominant today in terms of the amount of total foreign-source income it covers. Arguably, the overall limitation has always been dominant: even when the

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[16] *Id.*, 866 and 876, respectively.

[17] "Your committee has been assured that the Secretary of the Treasury will be reasonable in exercising this authority and will permit, for example, taxpayers to shift back to the per-country limitation where they are about to enter substantial operations in a new foreign country and anticipate that the operations in that country will prove quite risky with the possibility of their resulting in a loss for a number of years. Also, it is understood that he will permit taxpayers to shift back to the per-country limitation where substantial losses are realized with respect to existing investments because of nationalization, expropriation, or war. Similarly, it is expected that the Secretary or his delegate will develop appropriate rules allowing a taxpayer, upon a proper showing, to shift back to the overall limitation where he previously had the consent of the Secretary to use the per-country limitation." S. Rep. No. 1393, 86th Cong., 2d Sess. 877 (1960).

[18] *Id.*, 887.

[19] S. Rep. No. 313, 99th Cong., 2d Sess. 302-303 (1986).

[20] Elisabeth Owens, The Foreign Tax Credit 307, 314 (1961).

per-country limitation applied, a foreign holding company with subsidiaries in multiple foreign jurisdictions was permitted to average the foreign taxes paid to those multiple jurisdictions.[21] In effect, then, an overall limitation existed for foreign holding companies during the tenure of the per-country limitation.

D. Per-Country Limitation Eliminated and Overall Foreign Loss Recapture Rule Adopted

Subsequent changes to the foreign tax credit limitation further illustrate the concern with preserving the U.S.-source income tax base. The Tax Reform Act of 1976 eliminated the per-country limitation, leaving the overall limitation as the principal limitation on the credit.[22] Congress expressed the view that the per-country limitation was disadvantageous to the U.S. government because it allowed a U.S. taxpayer to use a foreign country loss to offset U.S.-source income with the possibility that subsequently earned income in the loss country also would not be taxed in the United States due to the foreign tax credit. Congress said that allowing taxpayers to use a loss from a foreign country to offset U.S.-source income and then later to claim a foreign tax credit on income earned in that country (where the country did not have a net operating loss carryover) was a double benefit to taxpayers at the expense of U.S. tax on U.S.-source income. Congress concluded that this double benefit to taxpayers could be partially eliminated if the per-country limitation were repealed and taxpayers required to use the overall limitation.[23]

The 1976 repeal of the per-country limitation was intended to ensure that foreign losses in a particular foreign country offset other foreign-source income before offsetting U.S.-source income. The double benefit concern on which Congress acted in 1976 had been considered earlier during its passage of the Tax Reform Act of 1969 and again in 1974.[24]

In 1976, Congress also enacted the OFL recapture rule of section 904(f) of the Code to address the double benefit concern. Even under the overall

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[21] *See, e.g.*, S. Rep. No. 1393, 86th Cong., 2d Sess. 876-77 (1960).

[22] P.L. 94-455, §§ 1031(a), 1032(a) and 1034(a).

[23] H.R. Rep. No. 658, 94th Cong., 1st Sess. 225 (1976); S. Rep. No. 938, 94th Cong., 1st Sess. 236 (1976); Conf. Rep. No. 1515, 94th Cong., 1st Sess. 458-59 (1976). It does not appear that Congress considered in 1976 that, under a per-country limitation, a loss in one foreign country might have been required to offset income in other foreign countries first, *i.e.*, before it offset U.S.-source income, in the manner that separate limitation losses in one foreign-source income category today offset income in other foreign-source income categories first under § 904(f)(5). Congress also apparently did not consider returning to the solution to the double benefit concern effected in 1932, *i.e.*, mandating the lesser of the per-country and overall limitations.

[24] McClure & Bouma, *supra* note 10, 1384, 1386.

limitation adopted in 1976, a net foreign-source loss in the overall limitation ultimately offsets U.S.-source income (if there is any) in the year of the loss, thereby reducing the U.S. tax on U.S.-source income. Section 904(f) prevents this offset from being permanent by recharacterizing foreign-source income earned in a year or years subsequent to the loss year as U.S.-source income in an amount equal to the lesser of 50 percent of foreign-source income (or a higher percentage at the option of the taxpayer) or the amount of the prior OFL. There is no time limit for the recapture of OFLs.

E. Look-Through Provisions in Deficit Reduction Act of 1984

Two foreign tax credit limitation amendments adopted in 1984 also were intended primarily to preserve the U.S. tax on U.S.-source income. First, the Deficit Reduction Act of 1984 introduced current section 904(g) of the Code, which preserves the U.S. sourcing of U.S.-source income that is received by a U.S.-owned foreign corporation and, absent section 904(g), would be converted to foreign-source income on its repatriation by the foreign corporation.[25] In essence, the foreign sourcing rules otherwise effective for dividends, interest, and subpart F income received from a U.S.-owned foreign corporation are overridden by section 904(g) for limitation purposes when that income can be traced to U.S.-source income received by the foreign corporation. Section 904(g) targeted certain offshore banking products designed to convert U.S.-source investment income of non-banking multinational investors into foreign-source overall limitation income.[26] Congress expressed concern in the 1984 legislative history that prior law permitted the foreign tax credit limitation to be circumvented and the U.S.-source income tax base to be eroded.[27]

The Deficit Reduction Act of 1984 also addressed the practice of taking interest income subject to the former separate foreign tax credit limitation for nonbusiness interest and recharacterizing that interest as income not subject to the separate limitation. As explained below, one purpose of this separate limitation was to prevent taxpayers with excess foreign tax credits from substituting foreign-source for U.S.-source interest income, which, in essence, resulted in avoidance of U.S. tax on U.S.-source income when the excess credits were used to shelter the interest income from U.S. tax.

[25] P.L. 98-369, §§ 121(a), 122(a), 801(d)(2), 474(r)(21).

[26] *See* T.A.M. 9611001 (December 5, 1996).

[27] S. Rep. No. 169, 98th Cong., 2d Sess., Vol. I, 387 (1984). Fair treatment of similarly situated taxpayers was also on Congress's mind in enacting I.R.C. § 904(g). The legislative history just cited also notes that U.S. taxpayers that earn U.S.-source income through foreign corporations should not be treated more favorably than U.S. taxpayers that earn U.S.-source income directly through foreign branches.

Accordingly, other things being equal, there was an incentive before 1984 for taxpayers with excess foreign tax credits subject to the overall limitation to move nonbusiness interest income subject to the separate limitation into the overall limitation, if possible.

Before the 1984 Act, the separate limitation for nonbusiness interest[28] excluded interest received from an affiliated foreign corporation in which the taxpayer had a 10 percent or greater voting stock interest ("affiliated party exception"). This exception allowed taxpayers to pass nonbusiness interest through a foreign affiliate to avoid the separate limitation. By having the nonbusiness interest paid to the foreign affiliate and then having the foreign affiliate pay interest or a dividend to the U.S. taxpayer, the interest was transformed from nonbusiness interest to foreign-source dividend income or interest eligible for the affiliated party exception. In either case, the income received by the U.S. taxpayer was assigned to the overall limitation rather than to the nonbusiness interest separate limitation.[29] The perceived incentive under pre-1984 law to invest overseas in a foreign corporation was not criticized on economic grounds, *i.e.*, because capital might be encouraged to move overseas; rather, it was criticized on the grounds that income that should have been U.S.-source income subject to full U.S. tax was being converted into foreign-source income that escaped U.S. tax. Thus, in Congress' view, the foreign tax credit limitation's original purpose of safeguarding the U.S. tax on U.S.-source income was being thwarted.

To combat the perceived problem, the 1984 Act provided that dividends and interest paid by certain U.S.-owned foreign corporations would be treated as interest, subject to the separate limitation for nonbusiness interest to the extent of the interest subject to the separate limitation for nonbusiness interest income that was received by the foreign corporation. This rule was subsumed in 1986 into the section 904(d)(3) look-through rules and separate limitation for passive income.

[28] *See* Chapter 3.III. of this report. Separate and special foreign tax credit limitations on certain categories of income are, relatively speaking, a more recent development in the history of the foreign tax credit. Under a separate foreign tax credit limitation, foreign taxes on the foreign income category at issue, for example, interest, cannot be credited against the U.S. tax on that income category (interest). Excess credits can be carried forward or back to other years to offset the U.S. tax on income in the category at issue in those other years. The per-country limitation in substance is a type of separate limitation although it is seldom referred to in that way. Some foreign tax credit limitations on specific categories of income have certain features different from those just described. These are referred to, for the sake of convenience, as "special" foreign tax credit limitations.

[29] S. Rep. No. 169, 98th Cong., 2d Sess., Vol. I, 392 (1984).

F. 1986 Act Separate Limitations

The legislative history of the 1986 Act notes that separate limitations are sometimes necessary to preserve the U.S. tax on U.S.-source income, specifically where income is manipulable as to source and, therefore, foreign-source income can readily be substituted for U.S.-source income.[30] The best example is the separate limitation for passive income. Thus, as recently as 1986, the foreign tax credit limitation's original purpose of preserving the U.S.-source income tax base was reaffirmed by Congress.

G. Separate Limitation Loss Allocation and Recapture Rules in Tax Reform Act of 1986

The separate limitation loss allocation and recapture rules in the Tax Reform Act of 1986 also reflected concern with the preservation of U.S. tax on U.S.-source income. Before the 1986 Act, the statute did not indicate whether a loss in a particular separate limitation category or the overall limitation category first offsets foreign-source income not subject to that particular limitation and only thereafter offsets U.S.-source income. Some taxpayers took the contrary position, that is, that separate limitation and overall limitation losses first offset U.S.-source income, reducing the U.S. tax thereon.[31] Proposed regulations issued under section 904(f) in January 1986 presumed that separate limitation and overall limitation losses offset U.S.-source income in the latter manner.[32]

Congress addressed this uncertainty in 1986, stating its belief that using separate limitation losses to reduce U.S.-source income rather than other foreign-source income inflated the foreign tax credit limitation and allowed foreign tax credits to reduce U.S. tax on U.S.-source income in the loss year.[33] The per-country limitation had been repealed to prevent foreign-source losses from reducing U.S.-source income before reducing other foreign-source income, but now the same undesired result was occurring under the separate limitation regime.[34]

The separate limitation loss provisions passed in 1986 and in effect today (section 904(f)(5)) provide that only if the aggregate amount of

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[30] *Id. See also* S. Rep. No. 313, 99th Cong., 2d Sess. 297-298 (1986).

[31] H.R. Rep. No. 426, 99th Cong., 2d Sess. 335-336 (1985).

[32] Preamble to proposed regulations under I.R.C. § 904(f), 51 Fed. Reg. 3193 (January 24, 1986).

[33] H.R. Rep. No. 426, 99th Cong., 2d Sess. 335-336 (1985).

[34] *Id.*

foreign-source losses in all limitations exceeds foreign-source income in other limitations will U.S.-source income be reduced and an OFL arise. To the extent that foreign losses in one or more limitations do not exceed foreign-source income in other limitations for the year, the losses are allocated on a proportionate basis among the limitations with foreign income that year.

IV. Conclusion

Protection of the U.S.-source income tax base was the original concern of the drafters of the foreign tax credit limitation and Congress has regularly invoked this concern in rationalizing later limitation modifications. Concerns about fair treatment of similarly situated taxpayers also played a role in the refinement of the limitation rules, at least in the early decades of their existence. Other concerns, including revenue needs, facilitating international operations of U.S. companies, worldwide allocation of capital and protection of the foreign-source income tax base, only subsequently became an issue in the continuing debates over the proper form of the foreign tax credit limitation.

Chapter 3

Use of Foreign Tax Credit Limitation to Affect Worldwide Allocation of Capital and Promote Other Goals

I. Introduction

The drafters' original focus on preserving the U.S. tax on U.S.-source income and treating similarly situated taxpayers fairly has competed more recently with other objectives, namely, the use of the foreign tax credit limitation to affect the worldwide allocation of capital. In this regard, concerns about capital export neutrality were important to international tax policymakers in the latter part of the 20th century,[1] although there was never strict adherence to this principle. The drafters of revisions to the foreign tax credit limitation also evidenced concern with facilitating the international operations of U.S. business and competitiveness or capital import neutrality (*i.e.*, the principle that all investment within a jurisdiction should bear the same amount of income tax regardless of the residence of the owners). The option discussed in Chapter 2 that permitted taxpayers to choose between the per-country and overall limitations illustrates Congressional support for facilitating international operations of U.S. companies. Policymakers' concern with capital import neutrality has increased in recent years, influencing, for example, the repeal of the noncontrolled section 902 corporation limitation.

[1] The term capital export neutrality did not appear in economic literature until 1963. *See* Peggy Brewer Richman, Taxation of Foreign Investment Income, An Economic Analysis, 1963.

Capital export neutrality concerns recently have focused on avoiding the creation of tax incentives to invest overseas. However, Congress historically has also considered the role of the foreign tax credit limitation and expense allocation and apportionment rules in creating incentives to forego foreign investment. With the recent substantial decline in foreign income tax rates relative to U.S. rates, the current separate limitation rules create distorting incentives to forego foreign investment that warrant close examination, as discussed in the final chapter of this report.

The foreign tax credit limitation rules have also been pressed into serving other policy goals including the pursuit of certain non-tax foreign policy goals and the resolution of income sourcing conflicts between the Internal Revenue Code and U.S. income tax treaties.

This chapter traces the widening and, sometimes conflicting, policy objectives of the foreign tax credit limitation, as reflected in various amendments since its original enactment.

II. Overall Limitation Eliminated

A concern that the Code potentially could hamper international business expansion resulted in the 1954 repeal of the overall limitation. From 1932 to 1954, taxpayers had been limited to the lesser of the per-country and the overall limitation. The repeal of the overall limitation left the per-country limitation as the only limitation in calculating the foreign tax credit.[2] In repealing the overall limitation, Congress looked at a perceived distorting incentive to *forego* foreign investment, not perceived distorting incentives to *make* foreign investment, which occupied center stage later. The overall limitation was repealed, according to the tax-writing committees, because it discouraged U.S. companies from expanding potentially profitable businesses from one foreign market into another country.[3] The disincentive arose because the overall limitation reduced the taxpayer's foreign tax credit below the amount allowed by the per-country limitation when the taxpayer had taxable income in one foreign country and a taxable loss in another. The committees believed that the incremental reduction of the foreign tax credit due to the foreign-source loss discouraged U.S. corporations that operated profitably in one country from expanding into other countries where they might operate at a loss during a start-up period.[4]

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[2] P.L. 83-591, § 904.

[3] *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 77 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 106 (1954).

[4] *Id.*

III. Separate Limitation for Nonbusiness Interest Income

In the Revenue Act of 1962,[5] Congress enacted the separate foreign tax credit limitation for certain nonbusiness interest income. That limitation was enacted out of concern that prior law improperly encouraged the movement of U.S. capital abroad, the opposite of the concern expressed in 1954. The Senate Finance Committee Report stated that:

> The Secretary of the Treasury in his appearance before your committee pointed out that last summer Canada revised its tax laws to provide a 57½ -percent effective rate of Canadian tax on income going to U.S. corporations operating in branch or subsidiary form in Canada. He stated that this Canadian tax, in excess of the U.S. 52-percent rate, has highlighted a procedure of using the foreign tax credit as an artificial inducement to the outflow of short-term U.S. capital. The Secretary stated that this was harmful to our monetary stability and balance-of-payments position.
>
> Under existing law, a U.S. corporation deriving income from business abroad through a branch or a subsidiary can be expected to have an unused foreign tax credit if the foreign tax rate exceeds the U.S. rate. However, if additional foreign-source income, such as interest, can be earned which is subject to a foreign tax rate that is lower than the U.S. rate, then the two types of income can be combined under the existing foreign tax credit rules. In this way the U.S. tax on the investment funds, which the foreign country taxes at a rate at much less than the U.S. rate, can be reduced or completely eliminated by being offset against the excess credit from the tax on the business income. For example, if U.S.-owned business operations are taxed in Canada at a 57½ percent effective rate, this leaves an excess credit of 5½ percentage points over and above the tax that can be credited against the U.S. 52-percent tax. The Canadian rate of tax on interest

[5] P.L. 87-834, §10(a).

> income, however, is only 15 percent. As a result, the U.S. company involved may transfer to Canada short-term funds, such as bank deposits, which would ordinarily be held in the United States. The excess credit from the business income in this case eliminates the U.S. tax on all, or a part, of the interest income, with the result that the interest income in effect is taxed at only a 15-percent Canadian rate as compared with the 52-percent U.S. rate which would apply if the funds were held here.
>
> The Secretary of the Treasury stated that the existence of this situation has served as an artificial inducement to the movement of U.S. capital abroad.[6]

The separate limitation for nonbusiness interest income contained several exceptions.[7] Its 1986 Act replacement, the separate limitation for passive income, is much stricter.

IV. 1986 Act Separate Limitations

The 1986 Act marked the acme of Congressional concern that the foreign tax credit limitation rules were providing inappropriate incentives to U.S. taxpayers to make marginal investments overseas.

A. Proposed Revival of Per-Country Limitation

In 1985, the Treasury Department published a comprehensive tax reform study that was the starting point for the 1986 Act.[8] The study included a proposal to substitute the per-country limitation for the overall limitation and a proposal to reduce U.S. tax rates substantially.

The Treasury Tax Reform Report expressed concern that the overall limitation could provide an inappropriate incentive for taxpayers to shift investment overseas. Taxpayer ability to readily generate low-taxed

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[6] S. REP. No. 1881, 87th Cong., 2d Sess. 73 (1962).

[7] The limitation applied to interest income other than interest: (i) derived from any transaction that was directly related to the active conduct of a trade or business in a foreign country or possession (such as interest income on accounts receivable of a foreign business arising from its ordinary business transactions); (ii) derived from the conduct of a banking, financing or similar business; or (iii) received from a corporation in which the taxpayer had at least a 10 percent voting stock interest. 1954 I.R.C. § 904(d). The limitation applied on a per-country basis even if the taxpayer was otherwise using the overall limitation.

[8] TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT Vol. 2, 360-363 (November 1984) [hereinafter "Treasury Tax Reform Report"].

foreign-source income using, for example, the title passage source rule for sales and the "greatly increase[d]" excess foreign tax credits expected from U.S. rate reductions were noted as issues. The previous problem under the per-country limitation of having U.S.-source income reduced by foreign losses was proposed to be dealt with by having a loss in one foreign country offset income in other foreign countries.

Treasury argued that a return to the per-country limitation would not penalize foreign investment because the proposed U.S. rate reductions and source rule changes, in combination with the per-country limitation, would produce a net reduction in U.S. tax on foreign-source income. Treasury's qualified commitment to capital export neutrality was evident in its rejection of the view that there was any problem with the per-country limitation's expansion of excess foreign tax credits.[9]

As discussed more fully in B., below, the Ways and Means Committee drafted a tax reform bill in 1985 that adopted a separate limitation rather than a per-country limitation approach and the tax reform legislation ultimately enacted in 1986 did the same.

B. Congressional Rationale for Separate Limitations

The 1986 Act substantially changed the foreign tax credit limitation provisions.[10] Although Treasury initially proposed to revive the per-country limitation, Congress rejected this approach in favor of expanding the number and scope of the separate foreign tax credit limitations.[11] The Ways and Means Committee Report contained an expansive discussion of the purpose of separate limitations that emphasized their role in curbing undesirable incentives to invest overseas:

> The committee believes that, in some cases, the present ability of U.S. persons to average foreign tax rates for foreign tax credit limitation purposes and to thereby reduce or eliminate the residual U.S. tax on their foreign income has undesirable consequences. Under present law, U.S. taxpayers with excess foreign tax credits have an incentive at the margin to place new investments abroad rather than in the United States when the income that those investments will generate will be taxed abroad at below the U.S. rate.

[9] *Id.,* Vol. I, 142, 144.

[10] P.L. 99-514, §1201.

[11] H.R. 3838, §§ 601 and 661(b).

> This is because the excess credits will reduce or eliminate the U.S. tax on the lightly taxed foreign-source income. This incentive is of particular concern in the case of investments that can quickly and easily be made in foreign countries rather than at home, for example, portfolio investments in stock in publicly traded companies.
>
> The committee is… concerned that, absent modification of the foreign tax credit limitation rules, the averaging opportunities that present law provides, coupled with other features of the bill, could tilt the relative balance of U.S. tax rules favoring foreign investment and U.S. tax rules favoring U.S. investment in favor of foreign investment.
>
> Several categories of income that are not presently subject to separate limitations present averaging problems similar to those presented by DISC dividends, FSC income, passive interest, and extraction income: that is, they frequently bear little foreign tax or abnormally high foreign tax, or are relatively manipulable as to source (U.S. or foreign).[12]

The House proposed separate foreign tax credit limitations for passive income (broadly defined), banking and insurance income, and shipping income. The Senate Finance Committee amended the House bill's foreign tax credit limitation provisions, in part, to reduce the bill's adverse effect on the international competitiveness of U.S. firms,[13] an example of Congressional treatment of capital import neutrality as a worthwhile goal.[14] Like the House bill, the Senate amendment adopted a separate limitation for passive income, but unlike the House bill it did not add separate limitations for other categories of income except high withholding tax interest.

The 1986 Act rate reductions were stated to be a major cause of Congress's concern about marginal incentives to invest overseas under the overall limitation. The 1986 Bluebook, for example, noted that: "Congress

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[12] H.R. REP. No. 426, 99th Cong., 2d Sess. 335-336 (1985). *See also,* S. REP. No. 313, 99th Cong., 2d Sess. 297-298 (1986).

[13] S. REP. No. 313, 99th Cong., 2d Sess. 309-320 (1986). The committee's report states that "the taxation of foreign income also is modified to restrict opportunities to use passive financial transactions to reduce tax liability on U.S. income, while not hindering the international competitiveness of U.S. firms."

[14] *Id.,* 329.

was concerned that the incentive to choose foreign over U.S. investment would be more pronounced in the future as a result of the Act's tax rate reductions: lower taxes (relative to foreign tax rates) cause many taxpayers to have more excess credits and more taxpayers to operate in excess credit positions."[15]

The 1986 Act replaced the separate limitation for nonbusiness interest income with a separate limitation for passive income generally. The stated impetus for this expanded separate limitation was Congressional concern that passive income tends to bear little or no foreign tax and that the source of many forms of passive income can be manipulated.[16] Congress was aware no doubt that the separate limitation for nonbusiness interest income had been adopted because of a perceived flight of capital to investment accounts outside the United States. The separate limitation for passive income prevents taxpayers from using high foreign taxes paid on other income to reduce or eliminate the residual U.S. tax on foreign-source passive income.

The conference agreement also contained an export financing exception to the passive income separate limitation. Interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property by the interest recipient or a related person, not more than 50 percent of the fair market value of which is attributable to products imported into the United States, is excluded from the passive income limitation and treated as overall limitation income. This provision was included because of the concern that the 1986 Act might otherwise have had the effect of reducing the availability of export financing, which could have had a negative impact on the volume of exports.[17]

The separate limitation for high withholding tax interest income generally includes all interest income that has borne a foreign withholding tax (or other tax determined on a gross basis) of 5 percent or more. The 1986 Bluebook recorded as one of Congress's concerns prior law's perceived encouragement of U.S. lenders to make loans to foreign rather than U.S. borrowers:

> A number of foreign countries, particularly developing countries, impose gross withholding taxes on interest earned by nonresident lenders that significantly exceed

[15] *See* Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. (1987) 862 [hereinafter "1986 Bluebook"].

[16] H.R. Rep. No. 426, 99th Cong., 1st Sess. 334 (1985); S. REP. No. 313, 99th Cong., 2d Sess. 303 (1986).

[17] Conf. Rep. No. 841, 99th Cong., 2d Sess. 565 (1986).

the general income taxes that would be imposed on the associated net interest income were it taxed on a net basis. In the case of U.S. lenders, these gross withholding taxes often far exceed the pre-credit U.S. tax on the net interest income as well. When a gross withholding tax equals the pre-credit U.S. tax, the U.S. lender pays no U.S. tax on loan proceeds associated with interest subject to the withholding tax under the United States' generally applicable foreign tax credit rules. When a gross withholding tax exceeds the pre-credit U.S. tax, the U.S. lender is subject to a negative rate of U.S. tax on the foreign loan transaction (as other U.S. taxpayers operating abroad sometimes are on other foreign transactions) to the extent that the lender uses the excess foreign tax credits to reduce its U.S. tax liability on other income, derived from the same foreign country or from other sources outside the United States, that is subject to little or no foreign tax. Income from domestic loans, by contrast, generally is subject to full U.S. tax. As a result of the foreign tax credit mechanism, the U.S. Treasury, in effect, bears the burden of these high levels of foreign tax on foreign loans.

The committee is concerned, moreover, that the available evidence suggests that the economic burden of high foreign gross withholding taxes on interest falls largely, in the typical situation, on the foreign borrower rather than on the U.S. lender. To the extent that is the case, the present rules allowing a full foreign tax credit for high foreign taxes on interest paid to U.S. lenders provide an incentive for some U.S. lenders to make foreign loans rather than domestic loans that would otherwise be equally attractive, and to make otherwise uneconomical foreign loans. The higher the applicable foreign tax on interest is, the larger the U.S. lender's foreign tax available for credit is, thus, the greater their incentive may be. The committee is particularly concerned that foreign countries seeking to attract U.S. capital may be encouraged by the present rules to

> increase rather than decrease their gross withholding taxes on interest paid to U.S. persons.[18]

The separate limitation for financial services income includes most income derived in the active conduct of a banking, insurance, financing, or similar business. The limitation was adopted primarily because of the perceived mobility of income earned in a financial services business and the perception that manufacturing companies with excess credits had an incentive under prior law to establish offshore banks to generate income that could be sheltered by such credits. Congress expressed concerned that prior law created too much of an incentive for companies to divert resources offshore in this fashion.[19]

The separate limitation for shipping income generally includes all income that is foreign base company shipping income for purposes of subpart F or that would be such income if received by a controlled foreign corporation (CFC). Thus, shipping income generally includes all income derived from the use of any aircraft or vessel in transporting persons or cargo from one country to another. The stated concern leading to this limitation's enactment was that shipping income was lightly taxed overseas and therefore U.S. multinationals with excess credits could effectively earn such shipping income free of U.S. tax by using those excess credits to shelter the income.[20]

V. Limitation for Dividends from Noncontrolled Section 902 Corporations

The 1986 Act also adopted a separate limitation for dividends from noncontrolled 902 corporations, which was criticized from the outset for the reasons discussed in Chapter 4. The Taxpayer Relief Act of 1997 repealed this limitation for reasons that included Congress's concern that the limitation inappropriately discouraged foreign investment in joint ventures. The recognition in 1997 that departures from capital export neutrality may also include distorting incentives to forego foreign investment was welcome and contrasted sharply with the 1986 Act's assumptions. The Ways and Means Committee report for the 1997 Act explained the repeal as follows:

[18] 1986 Bluebook, *supra* note 15, 864-865.

[19] *Id.*, 863-864.

[20] *Id.*, 864.

> The Committee finds that the present-law rule that subjects the dividends received from each so-called 10/50 company to a separate foreign tax credit limitation imposes a substantial record-keeping burden on companies and has the additional negative effect of discouraging minority-position joint ventures abroad. Indeed, the Committee is aware that recent academic research suggests that the present-law requirements may distort the form and amount of overseas investment undertaken by U.S.-based enterprises. The research findings suggest that the present-law limitation "greatly reduces the attractiveness of joint ventures to American investors, particularly ventures in low-tax foreign countries." Aggregate data indicate that U.S. participation in international joint ventures fell sharply after [enactment of present law] in 1986. The decline in U.S. joint venture activity is most pronounced in low-tax countries.
>
> Moreover, joint ventures in low-tax countries use more debt and pay greater royalties to their U.S. parents after 1986, which reflects their incentives to economize on dividend payments.
>
> The Committee believes that the joint venture can be an efficient way for American business to exploit its know-how and technology in foreign markets. If the present-law limitation is discouraging such joint ventures or altering the structure of new ventures, the ability of American business to succeed abroad may be diminished. The Committee believes it is appropriate to modify the present-law limitation to promote simplicity and the ability of American business to compete abroad.[21]

As the quoted passages indicate, Congress in 1997 also recognized the importance of fostering competitiveness under the U.S. international tax rules.

[21] H.R. REP. No. 148, 105th Cong., 1st Sess. 527-528 (1997).

VI. Research and Experimentation Expense Allocation Rules

The research and experimentation (R&E) expense allocation rules adopted by Congress in the 1980s are another example of Congressional sensitivity to the need to facilitate international operations of U.S. business and to avoid harming the competitiveness of U.S. companies. Capital export neutrality also figured in the debate on these rules, although the normal positions of business and government protagonists were in some sense reversed in that business representatives argued that prior law R&E expense rules inappropriately encouraged the shifting of business activity abroad. Prior law in this case was the 1977 R&E expense allocation regulations. Taxpayers in chronic excess foreign tax credit positions argued that those regulations were detrimental to R&E activities undertaken by U.S. corporations. Foreign countries would not, in some instances, allow deductions under their tax laws for R&E expenses relating to research activities performed in the United States, but these expenses were allocated to foreign-source income under the U.S. 1977 regulations. As a result, U.S. corporations tended to pay higher foreign taxes subject to a diminished foreign tax credit limitation and, due to the excess credits, were unable to receive a U.S. tax benefit. Critics charged that the regulations created an incentive for taxpayers to relocate their R&E activities abroad where a local deduction was available.

In response, Congress directed Treasury in the Economic Recovery Tax Act of 1981 to study the impact of the regulations on research activities conducted in the United States and the availability of the foreign tax credit.[22] Congress also enacted the first of several temporary suspensions of the 1977 regulations. Under these legislative "moratoria," taxpayers could allocate 100 percent of R&E expenditures to U.S.-source income.[23]

In 1983, Treasury submitted the mandated report to Congress.[24] The report concluded that the rules of the 1977 regulations primarily affected taxpayers in excess credit positions. Further, it was found that whether or not a taxpayer had excess credits did not appear to be closely related to the level of its research activities. The report noted that research activities are primarily located in foreign locations to transfer developed technology or to adapt technology to factors unique to the foreign market rather than to develop new technology for the world marketplace. The efficiencies inherent

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[22] H.R. REP. No. 201, 97th Cong., 1st Sess. 130-31 (1981).

[23] Economic Recovery Tax Act of 1981, P.L. 97-34, § 223. The first moratorium imposed a two-year suspension period on the application of the 1977 regulations.

[24] DEPARTMENT OF THE TREASURY, THE IMPACT OF THE SECTION 861-8 REGULATION ON U.S. RESEARCH & DEVELOPMENT (June 1983).

in centralized R&E activities were also cited as a disincentive to the establishment of offshore R&E facilities.

The report concluded that some allocation of R&E expense to foreign-source income is appropriate on the grounds that domestic R&E expense is exploited in foreign markets and generates foreign income. The lack of such an allocation results in a higher foreign tax credit limitation that may allow the foreign tax credit to reduce U.S. tax on U.S.-source income. However, Treasury acknowledged that a decrease in R&E activities had the potential to affect adversely the competitive position of U.S. companies in world markets and on these grounds recommended a two-year extension of the moratorium to allow time for Congress to study the report and develop a national program of R&E incentives.

In the Deficit Reduction Act of 1984, Congress extended the moratorium in the belief that it was appropriate both to require allocations of deductions between U.S. and foreign-source income and to provide tax laws encouraging U.S.-based research activities.[25] A further one-year extension was enacted as part of the Consolidated Omnibus Budget Reconciliation Act of 1985.[26] Temporary legislative compromises between a moratorium on the allocation of R&E expense to U.S.-source income, on the one hand, and the 1977 regulations' approach, on the other, were in effect from the enactment of the 1986 Act through the mid-1990s, after which a final compromise was adopted in Treas. Reg. § 1.861-17, in effect today. Other aspects of the R&E expense allocation controversy are discussed later in Chapter 4 of this report.

VII. No Section 78 Gross-Up for Dividends from Less-Developed Country Corporations

Another example of Congressional action to facilitate certain international business operations of U.S. companies can be found in the Revenue Act of 1962's treatment of less-developed country corporations. Among other changes, the 1962 Act added subpart F to the Code.[27] In addition, in the foreign tax credit arena, the Act created the section 78 gross-up for dividends carrying section 902 credits from foreign corporations. The section 78

[25] H.R. Rep. No. 861, 98th Cong., 2nd Sess. 1262-63 (1984).

[26] Consolidated Omnibus Budget Reconciliation Act of 1985, P.L. 99-272, § 13211.

[27] *See* The NFTC Foreign Income Project: International Tax Policy for the 21st Century; Part One: A Reconsideration of Subpart F (March 25, 1999) [hereinafter "NFTC Subpart F Report"].

gross-up places foreign subsidiaries and foreign branches on a more equal foreign tax credit footing. Specifically, the gross-up prevents U.S. shareholders of foreign corporations from effectively receiving a deduction as well as a foreign tax credit for taxes paid by the foreign corporations.[28] Importantly, however, the Revenue Act of 1962 contained exceptions from subpart F and the section 78 gross-up for less-developed country corporations.[29] The exception from the section 78 gross-up for less-developed country corporation dividends continued until the Tax Reform Act of 1976, which terminated the exception to make the tax treatment of less-developed country corporations and other corporations uniform and to simplify the credit computation.[30] Although the 1962 legislative history discussion of the less-developed country corporation exceptions is scant, it is reasonable to surmise that Congress adopted them to encourage U.S. business operations in less-developed countries, to spur international development and as a bulwark against the spread of Communism.[31]

VIII. Inventory Property Sales Source Rule

The inventory property sales source rule may treat as foreign-source income a substantial portion of the sales income earned on inventory property sales by U.S. companies. This foreign-source sales income often does not attract foreign tax, enhancing averaging potential for taxpayers with excess foreign tax credits. The inventory property sales source rule, with its focus on title passage, is easier to administer and comply with than a sales source rule focused on where the economic activity associated with the sale takes place. The durability of this source rule reflects Congress's historical commitment to facilitating international business operations of U.S. companies under the Code.

The statutory rule contained in current section 863(b) of the Code addressing the sourcing of income from cross-border inventory sales was enacted by the Revenue Act of 1921 and has remained in the statute without material

[28] *See* S. Rep. No. 1881, 87th Cong., 2d Sess. (1962).

[29] *Id. See also* Conf. Rep. No. 2508, 87th Cong., 2d Sess. (1962).

[30] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. 243 (1976).

[31] These provisions were adopted at the same time as provisions for increased domestic investment through adoption of an investment tax credit and others affecting foreign investment in developing countries and low-tax jurisdictions by application of the provisions of new subpart F. *See* NFTC Foreign Income Project, *supra* note 27, Chapter 2.I.

alteration since that time.[32] Before 1921, there was no specific sourcing rule for cross-border sales, *i.e.*, sales or exchanges of inventory property produced within the United States and sold outside the United States or vice versa. The Revenue Act of 1918 treated profits on the manufacture and disposition of goods within the United States as U.S.-source income.[33] The Senate Finance Committee's report on the source rule contained in the Revenue Act of 1921 expressed Congress's dissatisfaction with the failure of the 1918 Act source rule to separate the source of the income attributable to the manufacturing activities from the source of income generated by sales activities in cross-border sales. The report stated:

> The present law [the 1918 Act's source rule] is both obscure and economically unsound, inasmuch as the Attorney General has held that where goods are manufactured or produced in the United States and sold abroad, no part of the profit is derived from a source within the United States.[34] This section [the source rules of the 1921 Act–section 217] explicitly allocates certain important sources of income to the United States or to foreign countries, as the case may be, and with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States) authorizes the Commissioner, with the approval of the Secretary, to determine the income derived from sources within the United States either by rules of separate allocation or by processes or formulas of general apportionment.[35]

The 1921 statute (like the current statute) provides in general terms for the sourcing of income from the sale of property produced by a taxpayer (in whole or in part) within the United States and sold or exchanged outside

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[32] Revenue Act of 1921, ch.136, § 217(e), 42 Stat. 227, 244-245. § 217(e) only applied to nonresident aliens when enacted, but the sourcing rules therein were made applicable to U.S. taxpayers for purposes of applying the foreign tax credit provisions, by a statutory cross-reference enacted as part of the Revenue Act of 1932 (ch. 209, § 131(e), 47 Stat. 212).

[33] Revenue Act of 1918, ch.18, § 213(c) and 233(b).

[34] In 1920, the Attorney General had ruled that the income of a foreign corporation from the cross-border sale of goods that it had produced in the United States and sold abroad was all foreign-source income because such income did not arise from the "manufacture and disposition of goods within the United States." 32 OP. ATTY. GEN. 336 (1920).

[35] S. REP. 275, 67th Cong., 1st Sess. (Vol. 1) 16 (1921), 1939-1 C.B. (Part 2), 181, 192. The Committee reports from the 1921 Act were based largely on a document entitled NOTES ON THE REVENUE ACT OF 1918 submitted (November 3, 1918) for use by the Ways and Means Committee by Treasury, without recommendation.

the United States (or vice versa) as partly U.S. and partly foreign-source.[36] The details were left to Treasury, which was directed to promulgate regulations. Legislative regulations, issued in 1922,[37] contained three sourcing methods that have remained substantially the same, except for one material alteration, until the present day.

The 1922 regulations presented the methods for sourcing gross income derived from the sale of personal property produced within and sold outside the United States in the form of "cases."[38] Case 1 stated that where a manufacturer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish an independent factory or production price (IFP) and the selling concern of the manufacturer (with respect to other sales) is located in a country other than the place of manufacture, the U.S.-source portion of the income derived from such other sales is determined based on the IFP. The Case 1 method, therefore, appears to require both the establishment of an IFP and the taxpayer maintaining a selling or distributing branch or department outside the United States through which it sells the inventory property it produces in the United States.

Case 2 stated that in the case of sales where an IFP is not available, one-half of the net income from such cross-border sales is sourced based on the relative proportion of the taxpayer's property (defined as property that is involved in production of the export property) located within and outside the United States. The other half of the net income from the cross-border sales was originally sourced based on the relative proportion of the taxpayer's gross sales within and outside the United States. The regulations were subsequently amended with respect to Case 2 in 1957, so that the marketing component of the cross-border sales is now sourced based on where title to the goods passes (the "title passage rule").[39]

Case 3 outlined an allocation method based on the taxpayer's books and records that could only be adopted with the consent of the IRS.

Numerous legislative proposals have been advanced to amend the inventory property sales source rule. The 1984 Treasury Tax Reform Report recommended that income derived from manufacturing continue to be sourced based on place of manufacture, but that income from marketing and sales be sourced based on the taxpayer's country of residence, with

[36] I.R.C. § 863(b).

[37] Regs. 62, article 327 (1922).

[38] *Id.*

[39] Treas. Reg. § 1.861-7(c).

an exception to this rule where material participation in the sale by an office or branch outside the taxpayer's country of residence occurred.[40] Treasury stated its belief that this rule would correlate the source of sales income more closely with the location of the underlying selling activity without the administrative burden of determining in every case where the relevant sales activity occurred.[41]

The Administration's 1985 tax proposals adopted Treasury's recommendations.[42] The Administration also proposed that, under the second method, consideration could be given to increasing the percentage of income allocated to manufacturing activity.[43] The Administration's proposal was adopted in the House version of the 1986 Act, but was rejected by the Senate and the 1986 Act conference. The Senate Finance Committee Report states:

> The Committee is concerned that the repeal of the title passage rule for sales of inventory property would create difficulties for U.S. businesses to compete in international commerce. Moreover, the committee recognizes that with the substantial trade deficits of the United States, it does not want to impose any obstacles on U.S. business that may exacerbate the problems of U.S. competitiveness abroad.[44]

The 1986 Act directed the Treasury to conduct a study of the inventory property sales source rules, particularly in light of the lower tax rates enacted in 1986 and Congressional trade concerns.[45] Since 1986, the IRS/Treasury have sought to narrow or eliminate the inventory property sales source rule by legislative and other means.[46]

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[40] Treasury Tax Reform Report, *supra* note 8.

[41] *Id.*

[42] THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (May 1985).

[43] The Administration stated that it believed that the income sourced as foreign income under the title passage rule was unlikely to be taxed by foreign governments because many governments tax on an economic activity basis and because of the existence of the treaty network, which would also work to exempt the income from foreign tax.

[44] S. REP. No. 313, 99th Cong., 2d Sess. 329 (1986).

[45] § 1211(d) of P.L. 99-514, Tax Reform Act of 1986.

[46] Rev. Rul. 88-73, 1988-2 C.B. 173; T.D. 8228, 1988-2 C.B. 136; Notice 89-10, 1989-1 C.B. 631; Phillips Petroleum v. Commissioner, 97 T.C. 30 (1991); *Intel Corporation v. Commissioner,* 100 T.C. 616 (1993); H.R. 5270, Foreign Income Tax Rationalization and Simplification Act of 1992 § 203 (1992); Export Source Coalition's Testimony Against Limit on Export Source Rules at Ways and Means Subcommittee Hearings, 93 TAX NOTES 166-169 (September 21, 1993); DEPARTMENT OF THE TREASURY, INTERNATIONAL TAX REFORM, AN INTERIM REPORT, (1993); T.D. 8597, 1995-32 I.R.B. 36; API Objects to Single Entity Sourcing Rules in Proposed Consolidated Return Regulations, 9 TAX NOTES INT'L 653 (August 29, 1994); Preamble to T.D. 8597, 1995-32 I.R.B. 6; T.D. 8687, 1996-52 I.R.B. 4; JOINT COMMITTEE ON TAXATION, DESCRIPTION AND ANALYSIS OF CERTAIN REVENUE-RAISING PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1998 BUDGET PROPOSAL, JCS-10-97 (1997).

IX. Other Policy Purposes of Foreign Tax Credit Limitations

The stated purposes served by the various foreign tax credit limitations have included the advancement of non-tax foreign policy goals, the resolution of source rule conflicts between the Code and U.S. income tax treaties, and the collection of a minimum U.S. tax on foreign-source income.

In recent years, in the Omnibus Budget Reconciliation Act of 1986, Congress denied tax benefits with respect to activities in certain foreign countries disfavored under U.S. foreign policy.[47] A country is included on the disfavored list if it has been designated by the Secretary of State (pursuant to section 6(j) of the Export Administration Act) as a country that repeatedly provides support for acts of international terrorism, if it does not have diplomatic relations with the United States, or if the country has a government that the United States does not recognize (with certain exceptions).[48] Section 901(j) of the Code denies foreign tax credits generated from activities in listed countries and imposes a separate foreign tax credit limitation on the income from such activities. The Conference Report stated that "[i]ncome from one of these countries is subject to a separate foreign tax credit limitation, so that taxes from other countries cannot offset the U.S. tax on that income."[49]

The foreign policy focus of section 901(j) of the Code is not without some prior precedent in the foreign tax credit area. For example, it has been observed that U.S. foreign policy concerns significantly influenced tax policy towards the multinational oil corporations during the 1950s and much of the 1960s.[50] The foreign tax credit was used after World War II as an instrument to implement the U.S. foreign policy objectives of providing a steady supply of oil to post-World War II Europe and Japan, maintaining stable governments in the non-Communist oil producing countries and establishing a dominant position for U.S. multinational oil companies in the world oil trade.[51] This was accomplished by treating as creditable the usually high foreign oil and gas extraction taxes paid by U.S. multinational oil companies. Another example of foreign policy focus, discussed earlier in this chapter,

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[47] P.L. 99-509, § 8041(a). The Act's amendment to § 901 became effective on January 1, 1987.

[48] CONF. REP. No. 1012, 99th Cong., 2d Sess. 374 (1986). There was no House provision. South Africa was added to the disfavored list in 1988 because of its apartheid policies and removed in 1991.

[49] *Id.*

[50] *See* REPORT TO THE SENATE COMMITTEE ON FOREIGN RELATIONS, SUBCOMMITTEE ON MULTINATIONAL CORPORATIONS, MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY, 93d Cong., 2d Sess. (Comm. Print 1975).

[51] *Id.*

was the 1962 Act's less-developed country corporation exceptions that seem to have been enacted with international development and Communist containment in mind.

Controversy regarding potential 1986 Act overrides of income tax treaty source rules led to refined treaty/Code coordination provisions in the Technical and Miscellaneous Revenue Act of 1988.[52] That Act added, among other coordination provisions, section 865(h)(2), which provides that the U.S. sourcing rules in the Code for gain from the sale of stock in a foreign corporation or an intangible will yield to treaty foreign sourcing rules at the taxpayer's election. However, the gains for which foreign sourcing is permitted under this rule are subject to their own separate foreign tax credit limitation so that excess foreign tax credits generated outside the treaty country cannot be used solely by reason of the foreign sourcing provided by the treaty.

In the 1986 Act, Congress rewrote section 245(a), which governs the deduction for dividends received from foreign corporations. Section 245(a) now allows a dividends received deduction to a U.S. corporation for dividends from a qualified 10 percent-owned foreign corporation based on the U.S.-source portion of such dividends. For foreign tax credit limitation purposes, the portion of any dividend from a foreign corporation that is eligible for the dividends received deduction generally is treated as U.S.-source income. However, controversy regarding potential tax treaty overrides led to the 1988 Act's addition of section 245(a)(10), which provides foreign sourcing instead and eliminates the dividends received deduction at the taxpayer's election where a treaty provides foreign sourcing. Income that is foreign-sourced under this provision, like section 865(h), is subject to a separate foreign tax credit limitation.

The 1988 Act also created a separate limitation for dividends, interest and subpart F income derived from 50 percent U.S.-owned foreign corporations that would be treated under section 904(g) as U.S.-source income, but that a treaty treats as foreign-source income. If the taxpayer elects the benefit of such foreign sourcing, a separate limitation applies to the income in question.

Perhaps the most novel special limitation on the foreign tax credit is found in the 1986 Act alternative minimum tax provisions. The 1986 Act provided a new regime for computing alternative minimum tax. As part of this regime, the 1986 Act provided that the foreign tax credit cannot offset more than 90 percent of the pre-credit alternative minimum tax. Though not

[52] P.L. 100-647, § 1012(d)(8). *See also* Conf. Rep. No. 1104, 100th Cong., 2d Sess. 4 (1988).

a foreign tax credit limitation *per se*, the 90-percent rule causes a U.S. corporation with mostly or only foreign-source income to pay alternative minimum tax even if the corporation is subject to an effective foreign tax rate in excess of the U.S. alternative minimum tax rate. In such situations, the 90-percent rule produces double taxation of foreign-source income contrary to the foreign tax credit's purpose. Congress rationalized the 90-percent rule on the ground that it prevented taxpayers with substantial economic income from avoiding all U.S. tax using credits and losses.[53] The Taxpayer Refund and Relief Act of 1999 passed by Congress, but vetoed by the President, would have repealed the 90-percent rule.[54]

X. Conclusion

In recent decades, the focus of concern about worldwide allocation of capital among the foreign tax credit limitation's architects generally has been capital export neutrality. However, facilitating the international operations of U.S. companies and capital import neutrality also have received significant attention. As discussed in the final chapter of this report, cross-border investment cannot simultaneously enjoy both capital import and capital export neutrality when tax rates vary from country to country. Thus, tax policymakers interested in both principles must strike a balance between them.

The capital export neutrality concerns of tax policy makers have focused recently on avoiding tax incentives to invest overseas. The role that our foreign tax credit limitation rules may play in creating tax incentives to forego foreign investment received Congressional attention in the mid-20th century but has been mostly overlooked recently. As discussed in the final chapter, the capital export neutrality principle has never been strictly applied in the credit arena, *inter alia*, inasmuch as a strict application requires an unlimited foreign tax credit.

The foreign tax credit limitation's architects have also in recent years created new limitations to serve a growing variety of policy purposes unrelated to preserving the U.S.-source income tax base or affecting worldwide allocation of capital.

[53] 1986 Bluebook, *supra* note 15, 436.

[54] CONF. REP. No. 289, 106th Cong., 1st Sess. 247 (1999).

Chapter 4

Other General Observations Regarding the History of the Foreign Tax Credit

I. Introduction

The history of the foreign tax credit rules since 1918 is long and complex. Several general observations may be made about that history in addition to those already discussed in chapter 2 and chapter 3. First, the foreign tax credit rules have become much more complex and, at the same time, less certain in recent years. Second, revenue goals and constraints have sometimes molded the features of the foreign tax credit rules at the expense of sound tax policy, especially in the 1980s when many features of the current system were adopted. Third, the foreign tax credit limitation has been in existence for nearly 80 years but no consensus has ever been reached on a theoretically "correct" limitation formulation. Fourth, some redundancy has crept into the foreign tax credit rules over time. This chapter's account of certain major developments in the history of the foreign tax credit is organized around these general observations.

II. Increased Complexity of Foreign Tax Credit Rules

As all international tax practitioners are aware, the foreign tax credit rules have grown progressively more complex, especially in the last 20 years. Despite, or perhaps because of, the greater detail the foreign tax rules have taken on, their application has also become less certain. It would seem that Congressional and IRS/Treasury drafters have not always focused on the compliance and administrative costs of new regimes and refinements and have at times been unable fully to anticipate these systems costs. The foreign tax credit limitation rules, whether purposely or not, strike a balance between the pursuit of various tax and non-tax legislative goals, on the one hand, and administrability and certainty of result, on the other. While some complex rules are favorable to taxpayers in that they reduce the tax bill, the current balance tilts too far toward pursuit of tax and non-tax legislative goals and does not adequately consider compliance, administrative, and uncertainty costs. Examples of this imbalance addressed in this chapter include the passive limitation high-tax kick-out, which is highly complex but seems to address a largely theoretical abuse.

A. 1986 Act Amendments

The 1986 Act foreign tax credit and expense allocation and apportionment amendments, along with the IRS guidance interpreting them, represent a quantum leap in the complexity of the foreign tax credit and the uncertainty of its application. The issue is not simply the number of limitations introduced, but the fact that each limitation introduces a detailed set of rules for determining whether income is subject to that separate limitation. Additionally, for the various separate limitations to operate as intended, elaborate look-through and tax allocation rules are required that introduce another tier of complexities and uncertainties. Moreover, the 1986 Act created a complicated statutory regime for allocating and apportioning interest expense for foreign tax credit limitation and other purposes and added new loss allocation and recharacterization rules. These rules exacerbate the compliance and administrative burdens of taxpayers and the IRS.

In discussing the new separate limitations, the influential 1987 study on international taxation by the American Law Institute noted that the "proliferation of income categories exponentially increases the complexity of the statutory scheme."[1] However, the 1996 Committee Reports made scant mention of the compliance and administrative burdens created by the new limitations. While Congress examined many theoretical and policy issues before enacting the 1986 changes, it apparently did not foresee the more prosaic administrative and compliance complexities involved in applying the new limitation rules.

[1] American Law Institute, Federal Income Tax Project, International Aspects of United States Income Taxation 318, 347 (1987) [hereinafter "ALI Study"].

1. Separate Limitation for Passive Income

As discussed in Chapter 3, the 1986 Act replaced the separate limitation for nonbusiness interest income[2] with a separate limitation for passive income generally. The separate limitation prevents taxpayers from using high foreign taxes paid on other income to reduce or eliminate the residual U.S. tax on foreign-source passive income.

Passive income is defined for this purpose as any income of a kind that would be subpart F foreign personal holding company (FPHC) income.[3] Thus, to apply the passive limitation rules, one must master the subpart F FPHC rules. Passive income generally includes dividends, interest, and passive rents and royalties, but this generalization does not do justice to the intricacies arising under the subpart F FPHC rules. Questions such as whether a section 988 foreign currency gain arises in a transaction "directly related to the business needs" of the taxpayer and therefore escapes subpart F, whether a royalty is active or passive, and whether an

[2] Other separate limitations predating the 1986 Act were those for domestic international sales corporation (DISC) dividends, foreign sales corporation (FSC) dividends, and taxable income of a FSC attributable to foreign trade income. In 1971, Congress created the DISC to allow tax deferral on export income and thereby to mitigate some of the tax disadvantage U.S. exporters experienced vis à vis foreign exporters. A corporation may qualify as a DISC if it is a domestic corporation and meets a 95 percent qualified export receipt test and a 95 percent qualified export asset test. A DISC may defer tax on income attributable to $10 million or less of qualified export receipts. However, an interest charge is imposed on the shareholders of a DISC. The profits of a DISC are not taxed in the hands of the DISC but instead are taxed in the hands of the DISC shareholders when distributed or deemed distributed to them. Each year, a DISC is deemed to have distributed a portion of its income, thereby subjecting that amount of income to current taxation in the shareholders' hands. The tax deferral for the remaining income is intended to "mirror" the tax deferral available to U.S. companies operating abroad through foreign manufacturing subsidiary corporations. A foreign tax credit is available to DISC shareholders with respect to actual or deemed distributions from the DISC that are foreign-source. Dividends from a DISC (or former DISC) are treated as dividends from a foreign corporation to the extent the dividends are treated as foreign-source income. DISC dividends are considered foreign-source income to the extent attributable to qualified export receipts (other than interest from U.S.-sources) of the DISC. Congress imposed a separate foreign tax credit limitation on dividends from a DISC or former DISC, to the extent the dividends were foreign-source, to prevent the crediting of excess foreign tax credits on other types of income against the residual U.S. tax on the DISC dividends. I.R.C. § 904(d)(1)(F); H.R. REP. No. 533, 92d Cong., 1st Sess.182-183 (1971); S. REP. No. 437, 92d Cong., 1st Sess. 262 (1971). The expectation was that DISCs would normally attract little foreign tax. The Deficit Reduction Act of 1984 largely replaced the DISC regime with the FSC regime. P.L. 98-369, § 801(a). This section inserted new § 921-927, replacing old § 921, which dealt with Western Hemisphere Trade Corporations. This followed the United States' agreement in 1983 to replace the DISC with a territorial-type system of taxation for U.S. exports designed to comply with the General Agreement on Tariffs and Trade (GATT). A portion of the "foreign trade income" of a FSC is exempt from U.S. federal income tax at the corporate level. I.R.C. §921(a) and 923(a). Separate limitations are provided for taxable income attributable to foreign trade income and for distributions from a FSC (or former FSC) out of earnings and profits attributable to foreign trade income, interest or carrying charges. I.R.C. § 904(d)(1)(G) and (H). The stated purpose of these separate limitations is to prevent an increase in the overall limitation by these amounts of FSC-related income, which bear little or no foreign tax. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE DEFICIT REDUCTION ACT OF 1984, 1062-1064 (1984).

[3] Amendments to the definition of subpart F FPHC income enacted in the 1986 Act and in later enactments also generally apply for purposes of the separate foreign tax credit limitation for passive income.

item of income is high-taxed and therefore can be excluded from subpart F are but a few examples of the myriad interpretative issues arising in the subpart F FPHC area. FPHC inclusions (under section 551) and passive foreign investment company (PFIC) inclusions (under section 1293) also are passive income. Thus, one must also master the FPHC and PFIC regimes to apply the passive limitation rules. The PFIC rules may in turn be the single most complex body of rules in the international area.

Income meeting the definition of high withholding tax interest, financial services income or shipping income (defined in 4., below) is excluded from the definition of passive income. The conference agreement also contains an export financing exception to the passive income separate limitation (as explained in Chapter 3.IV.B.). The export financing exception is very narrow in scope. Parallel export financing provisions were enacted for the separate limitations for high withholding tax interest and financial services income.

The Senate-passed version of the 1986 legislation included a working capital exception, which excluded from the passive income limitation interest income derived from any transaction that is related to the active conduct by the taxpayer of a trade or business in a foreign country or U.S. possession.[4] Dividend income derived from any such transaction was also excluded if received from a regulated investment company by a taxpayer owning, directly or indirectly, less than 10 percent of the voting stock of the company. This provision resembled the working capital exception to the prior law separate limitation for nonbusiness interest. The conference agreement did not include the Senate working capital exception, but provided that a controlled foreign company (CFC) has no passive income (or other separate limitation income) in a taxable year in which the corporation has no subpart F income due to the application of the subpart F *de minimis* rule.[5] Congress adopted this *de minimis* rule for the separate limitations in the stated interest of administrative convenience,[6] although looking at the totality of the separate limitation rules, the administrative convenience offered by the *de minimis* rule is slight.

High-taxed income is excluded from the separate limitation for passive income (high-tax kick-out). The high-tax kick-out applies after allocation of expenses and only at the level of the U.S. person. Net foreign-source income that otherwise would qualify as passive income, with respect to

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[4] S. Rep. No. 313, 99th Cong., 2d Sess. 309 (1986).

[5] Conf. Rep. No. 841, 99th Cong., 2d Sess. Vol. II, 566 (1986). This provision is contained in current I.R.C. § 904(d)(3)(E).

[6] Conf. Rep. No. 841, 99th Cong., 2d Sess. Vol. II, 566 (1986).

which foreign income taxes were paid that exceed the U.S. tax on such income (*i.e.,* the highest U.S. tax rate multiplied by the amount of the income after expense allocation and apportionment), is excluded from the passive income separate limitation and treated as overall limitation income.

This provision was included in the House bill (but not in the Senate-passed version of the bill) "[t]o ensure that the separate limitation for passive income segregates low-taxed income from high-taxed income as intended and that substantial averaging within the passive basket is avoided…"[7] The 1986 Bluebook contains an example of a high-taxed foreign subsidiary engaging in a back-to-back loan transaction that has no local tax consequences but that increases passive income and reduces overall limitation income for U.S. tax purposes.[8] The result in the example is that high foreign tax is shifted from the overall to the passive limitation where it shelters low-tax passive income from U.S. tax. This example appears largely theoretical and, in any event, could have been addressed more simply with special expense allocation rules.[9]

The 1986 Act also adopted the Senate substitute for the high-tax kick-out that authorizes the Treasury Department to prescribe anti-abuse rules to prevent manipulation of the character of income, the effect of which is to avoid the purposes of the separate limitations.[10] This regulatory authority has never been exercised, presumably because extensive high-tax kick-out regulations have been issued.[11] These regulations group gross passive income into numerous "sublimitations" under a very difficult set of rules, allocate expenses among these groupings, assign taxes to the groupings, and then apply the high-tax test to each grouping. Tax allocation for these purposes presents a number of thorny issues.[12]

Kevin Dolan, who, as Associate Chief Counsel (International) at the IRS, oversaw the drafting of the regulations implementing the high-tax kick-out, describes the kick-out as "[p]erhaps the single greatest source of complexity in § 904(d)" and has proposed several alternatives.[13] David

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[7] H.R. Rep. No. 426, 99th Cong., 1st Sess. 340 (1985).

[8] *See* Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. 879-880 (1987) [hereinafter "1986 Bluebook"].

[9] D. Tillinghast, *International Tax Simplification,* 8 American J. Tax Policy 187, 219-220 (1990) [hereinafter "Tillinghast"].

[10] Conf. Rep. No. 841, 99th Cong., 2d Sess. Vol. II, 567 (1986).

[11] *See* Treas. Reg. §1.904-4(c).

[12] *See* Treas. Reg. §§1.904-4(c)(6) and 6(a)(1)(iv) and preamble to final § 904 regulations published in December 2000 (discussing §1.904-6(a)(1)(iv)).

[13] K. Dolan and C.M. DuPuy, *The Future of the Foreign Tax Credit—Some Preliminary Observations for Reform,* 8 Tax Mgt Int'l J. 487, 492 (December 8, 1989).

Tillinghast, the reporter for the ALI Study previously cited (in A., above), has stated that the kick-out "creates enormous complexity" and remarked that the need for its existence "is far from clear."[14] When one weighs the perceived problem the kick-out addresses and the possibility of less burdensome solutions to that problem against the compliance and administrative headaches the kick-out causes, the kick-out seems hard to justify.

2. Separate Limitation for High Withholding Tax Interest

The separate limitation for high withholding tax interest income generally includes all interest income that has borne a foreign withholding tax (or other tax determined on a gross basis) of 5 percent or more. The 1986 Act legislative history in the Bluebook acknowledged the importance of administrative simplicity in applying this separate limitation and indicated that a gross basis statutory rate, rather than an effective net rate, was used definitionally to avoid the necessity of computing the net U.S. tax on interest income.[15] As noted, the effective rate calculation eschewed here was embraced in the passive limitation high-tax kick-out. Because the separate limitation for high withholding tax interest income applies to any taxpayer earning such interest income, not only banks and insurance companies, it affects the compliance function of many other U.S.-based multinationals.

3. Separate Limitation for Financial Services Income

The separate limitation for financial services income includes most income derived in the active conduct of a banking, insurance, financing or similar business. Congress emphasized that the separate limitation for financial services income was not intended to curtail averaging within or between financial services businesses.[16] Nonetheless, difficult issues arise, among other reasons, because only "financial services entities" earn financial services income and the rules for determining what constitutes a financial service entity are intricate and sometimes confusing. The regulations apply an 80 percent gross income test to determine if an entity is a financial services entity. Only income falling within a subset of financial services income is counted in applying the 80 percent test, which also features difficult look-through rules and special rules for partnerships and affiliated groups.[17]

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[14] Tillinghast, *supra* note 9, 219-20.

[15] 1986 Bluebook, *supra* note 8, 864-865.

[16] *Id.,* 863-864.

[17] *See* Treas. Reg. §1.904-4(e)(3).

4. Separate Limitation for Shipping Income

The separate limitation for shipping income generally includes all income that is foreign base company shipping income for purposes of subpart F or that would be such income if received by a CFC. Thus, shipping income generally includes all income derived from the use of any aircraft or vessel in transporting persons or cargo from one country to another. Like the separate limitation for passive income, the separate limitation for shipping income requires mastery of the subpart F rules before the limitation can be applied. This separate limitation affects all industries that engage in shipping, such as the oil and gas industry, not only the shipping industry. Income sometimes falls initially in both the shipping category and some other subpart F category and/or some other separate limitation category, necessitating the application of two sets of priority rules, one under subpart F and one under the foreign tax credit limitation.[18]

5. Separate Limitation for Dividends from Noncontrolled Section 902 Corporations

The separate limitation for noncontrolled section 902 corporations includes dividend income received with respect to each stockholding (of at least 10 percent by a U.S. corporate taxpayer) in a noncontrolled section 902 corporation. Generally, a noncontrolled section 902 corporation is any foreign corporation that is not controlled by U.S. persons and that has at least one 10-percent U.S. corporate shareholder. There is a "separate" separate limitation for dividends from each noncontrolled section 902 corporation in which the U.S. taxpayer owns shares.[19]

The separate limitation for noncontrolled corporations was adopted in conference. It has been criticized because of its late adoption, the presumption underlying the limitation that minority U.S.-owned foreign corporations could not obtain the information needed to apply the look-through rules of section 904(d)(3) to such dividends, the multiple limitations involved, and the complexities when noncontrolled section 902 corporations convert to CFCs or change their U.S. shareholders.

The Taxpayer Relief Act of 1997 attempted to abate some of these complexities and, after 2002, generally repeals this separate foreign tax credit limitation. The 1997 Act substitutes the look-through rules of section 904(d)(3) to characterize dividends from noncontrolled section 902

[18] *See* Treas. Reg. §§1.954-1(e) and 1.904-4(i).

[19] I.R.C. § 904(d)(2)(E).

corporations paid out of post-2002 earnings.[20] Dividends received from noncontrolled section 902 companies in taxable years beginning after 2002, but derived out of earnings accumulated before such years, by contrast, will generally be combined into a single separate limitation for all dividends from noncontrolled section 902 companies. This single separate limitation rule does not apply if the corporation is also a passive foreign investment company as defined in section 1297. Dividends received from noncontrolled section 902 companies in taxable years beginning before 2003 remain subject to the 1986 Act rules. The repeal rules for the noncontrolled section 902 corporation limitation, it will be noted, are themselves quite complex. The Taxpayer Refund and Relief Act of 1999 passed by Congress, but vetoed by President Clinton, would have accelerated the effective date of the repeal and simplified the repeal rules in some respects.[21]

6. Look-Through Rules

The 1986 Act provided look-through rules in section 904(d)(3) of the Code for applying the 1986 Act separate limitations to dividends, interest, rent, royalties and subpart F income received from related CFCs and certain other related parties. The 1986 Bluebook described the rationale for the look-through rules as follows:

> In Congress' view, a dividend received by a 10-percent shareholder of a CFC, for example, should not automatically be treated as 100-percent passive income. Look-through rules reduce disparities that might otherwise occur between the amount of income subject to a particular limitation when a taxpayer earns income abroad directly (as through a foreign branch), and the amount of income subject to a particular limitation when a taxpayer earns income abroad through a CFC.[22]

It is also generally agreed that look-through rules are necessary to prevent taxpayers from circumventing separate limitations by using a foreign

[20] P.L. 105-34, § 1105(a)(1).

[21] H.R. Rep. No. 289, 106th Cong., 1st Sess. 163 (1999).

[22] 1986 Bluebook, *supra* note 8, 866-867. The predecessor of the 1986 Act look-through rules was the 1984 Act rule that maintained the character of separate limitation nonbusiness interest by treating dividends and interest paid by certain U.S.-owned foreign corporations as separate limitation nonbusiness interest to the extent the foreign corporation earned such interest. *See* P.L. 98-369, §§ 121(a), 122(a), 801(d)(2), 474(r)(21).

holding company.[23] Congress explained the extension of the look-through regime to interest, rents, and royalties as follows:

> Congress decided to subject interest, rents, and royalties, in particular, to look-through rules because such payments often serve as alternatives to dividends as a means of removing earnings from a CFC or other related person. In addition, Congress believed that interest, rents, and royalties from CFCs generally should be treated for look-through purposes like dividends from CFCs[24] so that payment of the former would not be discouraged. Interest, rents, and royalties generally are deductible in computing tax liability under foreign countries' tax laws while dividend payments generally are not; thus, in the aggregate, interest, rent, and royalty payments reduce foreign taxes of CFCs more than dividend payments do. Under the foreign tax credit system, the payment of interest, rents, and royalties by CFCs may, therefore, reserve for the United States more of the pre-credit U.S. tax on these corporations' foreign earnings than the payment of dividends.
>
> Congress thought it desirable to limit the application of the look-through rules and to make their application, where required, as simple as possible for taxpayers and the IRS. To that end, the Act, where feasible, conforms the separate limitation look-through rules to the subpart F rules.[25]

The last two quoted sentences suggest the drafters were aware of the intricacy of the look-through rules and hoped to forestall criticism by including some simplification features. The subpart F/look-through conformity referred to includes the *de minimis* exception discussed above in the context of the separate limitation for passive income. This rule allows U.S. shareholders of CFCs to avoid applying the look-through rules to limited amounts of income in any separate limitation category (except financial services income) earned by such corporations.[26] Another

[23] ALI Study, *supra* note 1, 326.

[24] Absent an applicable look-through rule, interest, dividends, and passive rents and royalties are generally fully subject to the separate limitation for passive income.

[25] 1986 Bluebook, *supra* note 8, 866.

[26] *Id.*, 866-867; I.R.C. § 904(d)(3)(E).

subpart F/look-through conformity rule exempts from the passive income limitation dividends paid by CFCs from passive earnings that were excluded from subpart F under the high-tax exception of section 954(b)(4).[27] There remains, however, a considerable lack of conformity between subpart F and the separate limitation look-through rules. For example, related party payments generally are not characterized on a look-through basis under subpart F and subpart F is based on annual income accounting while the look-through rules classifying subpart F inclusions for limitation purposes work off of multi-year section 902 pools of earnings and foreign taxes.

The look-through rules for subpart F inclusions, dividends, interest, and rents and royalties are generally different from one another, adding to their complexity. The look-through rules for interest are the most demanding and include an interest-netting rule to avoid creating an incentive for taxpayers to keep or move passive income and investments offshore. This rule requires that interest payments by a CFC to related persons first be allocated to passive limitation FPHC income of the CFC for subpart F and look-through purposes, as opposed to allocating these interest payments *pro rata* among all separate limitation categories of income of the CFC, which is the normal methodology under the look-through rules. As a result, interest payments by a CFC to its U.S. shareholders are separate limitation passive income in the hands of those shareholders to the full extent of the foreign corporation's gross passive FPHC income.[28]

The look-through regulations fill 15 single-spaced pages of small print and cover payments not only by CFCs but also by PFICs, U.S. corporations, partnerships and other pass-through entities. There are rules for determining which related party payments are subjected to look-through treatment first,

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[27] 1986 Bluebook, *supra* note 8, 866-867.

[28] *Id.,* I.R.C. § 954(b)(5). The Conference Report provides the following example of the application of the interest-netting rule: assume that a U.S. corporation wholly owns a foreign corporation and that the U.S corporation also has $1,000 of cash. That CFC earns $100 of overall limitation manufacturing income, on which it pays $60 of foreign tax. The U.S. parent is free to invest its cash in the United States or abroad. Assuming equally safe investments, the parent will tend to seek the highest after-tax return. If the U.S. parent earns $100 of bank deposit interest in the United States, it will generally pay $34 of U.S. tax on that interest income … Assume that the parent… lends its $1,000 of cash to its CFC. The foreign corporation deposits that cash in a foreign bank and earns $100 of interest on the investment. The foreign subsidiary in turn pays $100 of interest to its U.S. parent… Under the netting rule, the $100 interest payment is properly allocable in full to the CFC's $100 of gross bank deposit interest, which is gross subpart F FPHC income subject to the separate limitation for passive income. Thus, the $100 of interest received by the U.S. parent is subject to the same separate limitation for passive income. As a result, the U.S. parent cannot cross-credit foreign taxes paid on overall limitation income against the U.S. tax liability on that income. The $100 interest payment in effect removes all the passive income at the foreign subsidiary level. There is no subpart F inclusion for this taxable year. Any future dividends from the foreign subsidiary from its $100 of pre-foreign tax manufacturing earnings will consist solely of overall limitation income. CONF. REP. No. 841, 99th Cong., 2d Sess. Vol. II 578-579 (1986).

rules for entities that both make and receive look-through payments, and a variety of exceptions and special rules for specific fact patterns.[29] Computer software can assist in the application of the look-through rules, but human beings still must grapple with numerous interpretative issues.

7. Tax Allocation

The 1986 Act did not provide statutory rules for allocating foreign taxes to the various separate limitations, but anticipated that regulations would address this issue. The 1986 Bluebook indicated that tracing of foreign taxes to particular income, where possible, should occur to limit averaging. The model envisioned for the tax allocation rules was the tax allocation regulations then applicable to the separate limitation for nonbusiness interest and the special limitation for foreign oil and gas extraction income (FOGEI).[30]

The FOGEI regulations generally allocate taxes for purposes of the special foreign tax credit limitation for such income based on income as computed under foreign, rather than U.S., law.[31] The separate foreign tax credit limitation regulations issued in 1988 and now in effect adopt a similar method of allocating foreign taxes to the separate limitations based on foreign law income measurement.[32] This is the sole purpose for which income is measured under foreign law to compute the credit; all other credit computations are based on U.S.-measured income. The tax allocation regulations, thus, layer on an additional computational burden for a limited purpose. While the use of foreign-measured income is probably appropriate as a theoretical matter, to prevent distortions in the allocation of foreign tax, it is fair to ask whether the distortions avoided justify the additional compliance and administrative burden.

One of the most interpretatively troublesome tax allocation regulations addresses foreign tax imposed when an item of income is recognized under foreign law, but not U.S. law, in a particular year.[33] The regulations allocate the foreign tax to the overall limitation if the income is permanently exempt under U.S. rules, but to the limitation the income is normally assigned to if it is recognized in a different year for U.S. tax purposes than for foreign tax purposes. In practice, distinguishing permanent exemptions from timing differences is often difficult, as for example, in the tax-free

[29] *See* Treas. Reg. §1.904-5.

[30] 1986 Bluebook, *supra* note 8, 902.

[31] Treas. Reg. §1.907(c)-3(a)(5).

[32] Treas. Reg. §1.904-6.

[33] Treas. Reg. §1.904-6(a)(1)(iv).

reorganization and check-the-box contexts. The IRS acknowledged such difficulties in the preamble to the final section 904 regulations published in December 2000.

8. Interest Expense Allocation and Apportionment

The interest expense allocation and apportionment rules adopted in 1986 introduced another major source of complexity in computing the foreign tax credit limitation.

Section 863 provides that items of gross income, expenses, losses, and deductions, other than those specifically identified in section 861(a) and 862(a), should be apportioned to sources within or outside the United States under regulations. Before 1986, this statute governed the allocation and apportionment of interest expense and provided no further detail on the methodology the regulations were to use.

Until 1977, the applicable regulations provided considerable flexibility to taxpayers regarding the allocation and apportionment of interest expense, like other expenses not specifically identified. The text of the regulations (adopted in 1957) was very brief:

> From the items of gross income specified as being income from sources from within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income.[34]

With respect to interest expense, the courts interpreted the regulations by adopting one of two approaches, depending on the facts and

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[34] Treas. Reg. §1.861-8(a), 1957-2 C.B. 368. The apportionment methodology outlined in the 1957 regulations was unchanged from the apportionment methodology in the original regulations addressing this issue. The original Treasury Regulations (article 325 of Regulations 62, issued under the Revenue Act of 1921) provide: "Apportionment of deductions. –From the items specified in Articles 317-323 as being derived specifically from sources within and without the United States, there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. The remainder shall be included in full as income from sources within the United States. The ratable part is based upon the ratio of gross income from sources within the Unites States to the total gross income." All regulations promulgated subsequent to the 1921 Act regulations and up until 1977, continued to apportion the 'not definitely allocable' expenses on a gross income basis.

circumstances.[35] In some instances, interest was allocated and apportioned based on a tracing of the use of the loan proceeds.[36] In other cases, interest was allocated and apportioned based on gross income.[37] The 1957 regulations provided no guidance on whether the allocation and apportionment was to be performed on a company-by-company basis or on a consolidated basis. Interpreting pre-1977 law, the Court of Claims held, in 1979, that the apportionment of expenses, losses and other deductions that were not specifically allocable should be performed on an affiliated group basis, rejecting the IRS's argument that the computation should be performed on a company-by-company basis.[38]

Treasury issued final regulations in 1977 that addressed the allocation and apportionment of expenses and offered specific guidance regarding interest expense.[39] The factual relation of each deduction to gross income was emphasized and with respect to interest, an apportionment method based on assets, as well as a gross income apportionment method, was included in the regulations.[40]

The 1977 regulations provided that if an affiliated group of corporations joined in filing a consolidated return under section 1501, the allocation and apportionment provisions, including those relating to interest expense, were to be applied separately to each member in that affiliated group for purposes

[35] Zimmerman, *Allocating and Apportioning Interest Deductions under the Final 861 Regulations,* 49 J. TAX. 302 (November 1978).

[36] *See, e.g., Commercial Union Assurance Co., Ltd.,* 144 F.2d 994 (2d Cir., 1944*); Missouri Pacific Railroad,* 392 F.2d 592 (Ct. Cl. 1968); *Chicago, Milwaukee, St. Paul & Pacific Railroad,* 404 F.2d 960 (Ct. Cl. 1968); and *F.W. Woolworth Co.,* 54 T.C. 1233 (1970), *nonacq.,* 1971-2 C.B. 4.

[37] *See, e.g., Yokohama Ki Ito Kwaisha Ltd.,* 5 B.T.A. 1248 (1927), acq.; *Third Scottish American Trust Co., Ltd.,* 37 F. Supp. 279 (Ct. Cl. 1941); *Balfour Williamson & Co., Ltd.,* T.C.M. 3/30/43; *International Standard Electric Corp.,* 1 T.C. 1153 (1943), *acq., aff'd and modified,* 144 F.2d 487 (2d Cir. 1944), *cert. den.* 323 U.S. 803 (1945).

[38] *International Telephone & Telegraph Corporation v. United States,* 608 F.2d 462 (Ct. Cl. 1979).

[39] T.D. 7456, 1977-1 C.B. 200.

[40] The 1977 regulations were the culmination of an effort to update the expense allocation and apportionment regulations that dated back to 1965 when proposed regulations regarding expense allocation and apportionment were issued. Prop. Treas. Reg. §1.861-8 (1966). The 1965 proposed regulations were withdrawn when new proposed regulations were issued in 1966 and the 1966 regulations were withdrawn when yet another set of proposed regulations was issued in 1973. The 1973 proposed regulations moved away from the flexible approach of the earlier regulations and proposed a more detailed, factual analysis of each deduction that ignited an intense debate among taxpayers, tax practitioners and the government. Mihalov, *Current Problems of Allocating and Apportioning Deductions to Foreign Income*, 45 J. TAX. 110 (August 1976). The 1973 proposed regulations, like their predecessors, were ultimately withdrawn and a fourth set of proposed regulations was published in 1976. Taxpayers commented that the general effect of the proposed regulations was to increase double taxation. *See, e.g.,* Fox and Jackson, *Washington Tax Watch,* 4 J. CORP. TAX. 47 (1977). In addition, it was charged that the 1976 proposed regulations failed to take into consideration expenses, including interest expense, of a foreign subsidiary when the U.S. parent's expenses were allocated, resulting in additional expenses being allocated to foreign-source income and a higher effective tax rate for the U.S. corporation. Despite the controversy generated by the 1976 proposed regulations, these regulations were finalized with only minor revisions in 1977. *Id.*

of determining such member's taxable income.[41] Generally, the regulations provided that the aggregate of deductions for interest expense would be considered related to all income-producing activities and properties of the taxpayer, and thus was allocable to all gross income of the taxpayer. This treatment of interest expense was based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of the purpose for incurring the interest expense. The regulations contained a narrow exception to the general apportionment of interest expense for interest on certain nonrecourse debt.[42] The 1977 regulations included two methods for the apportionment of interest expense: the asset method and the gross income method. In establishing the asset method as the preferred method, the regulations stated:

> Normally, the deduction for interest expense relates more closely to the amount of capital utilized or invested in an activity or property than to the gross income generated therefrom, and therefore the deduction for interest should normally be apportioned on the basis of asset values. Indebtedness permits the taxpayer to acquire or retain different kinds of assets that may produce substantially different yields of gross income in relation to their value. Thus, apportionment of an interest deduction on such basis as gross income may not be reasonable.[43]

In response to perceived taxpayer efforts to limit artificially the interest expense allocated to foreign-source income by manipulating the location of the borrowing within an affiliated group, Treasury in 1984 recommended the elimination of the separate company method of apportionment.[44] In its Report to the President on Tax Reform for Fairness, Simplicity and Economic Growth, Treasury recommended apportionment of interest on

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[41] Treas. Reg. §1.861-8(a)(2) (1977).

[42] Treas. Reg. §1.861-8(a)(2)(iv) (1977). Qualifying interest on nonrecourse debt was allocated directly to the class of gross income that the property subject to the debt generated, had generated or could reasonably have been expected to generate. For interest expense to qualify for the nonrecourse debt exception, the following requirements had to be met: (i) the debt on which the interest was paid was specifically incurred for the purpose of purchasing, maintaining or improving the specific property; (ii) the proceeds of the debt were actually used for this purpose; (iii) the creditor had recourse only to the specific property as security for payment of the principal and interest of the loan; (iv) it could reasonably be assumed that the cash flow from the specific property was adequate to service the interest on the loan and ultimately to repay the principal; and (v) there were restrictions in the loan documents on the disposal and use of the specific property that were consistent with the requirements at (i) to (iv).

[43] Treas. Reg. §1.861-8(e)(2)(v) (1977).

[44] Tax Reform for Fairness, Simplicity, and Economic Growth, The Treasury Department Report to the President Vol. 2, 367 (November 1984).

a combined group basis for taxable years beginning on or after January 1, 1986. The President's Budget Proposal for Fiscal Year 1986 adopted this recommendation.[45] The House version of the Tax Reform Act of 1986 generally provided for the apportionment of interest expense as if the affiliated group were one taxpayer. In addition, the House bill modified the asset method of apportioning interest by providing for the stock basis of a foreign corporation owned by a 10-percent or greater U.S. shareholder to be adjusted by the earnings and profits of the foreign corporation attributable to the stock and accumulated during the period when the U.S. shareholder held the stock. The optional gross income method of apportioning interest expense in the 1977 regulations was eliminated for U.S. companies based on the belief that the asset method more closely reflected economic reality.[46]

The Senate-passed version of the 1986 bill provided for apportionment of interest expense based on an expanded affiliated group that included both foreign corporations that would be eligible to consolidate were they not foreign and possessions corporations that would be eligible to consolidate absent statutory prohibition.[47] The Senate version of the bill, unlike the House version, thus considered foreign-borne interest expense in apportioning the interest deduction of the U.S. members of the group so as to adhere more closely to a worldwide fungibility approach to interest expense apportionment.[48] The Senate bill also provided a special rule for non-guaranteed third-party debt of a U.S. member of an affiliated group below the top corporate tier. Under this provision, sometimes referred to as the Baucus amendment after its architect, Senator Baucus of Montana, the U.S. member of the affiliated group that incurred interest expense with respect to qualified indebtedness (*i.e.,* non-guaranteed third-party debt) could elect to allocate and apportion the interest expense as though the member were the ultimate U.S parent of an affiliated group consisting of the member and its direct and lower-tier subsidiaries. The election by one U.S. member of an affiliated group to apply this "look-down" approach required that such treatment be applied to all qualified interest of all U.S. members of the group.[49]

[45] THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY, 404 (May 1985).

[46] H.R. REP. No. 426, 99th Cong., 2d Sess. 376 (1985). It should be noted that CFCs are still permitted to use an optional modified gross income method when apportioning interest expense.

[47] S. REP. No. 313, 99th Cong., 2d Sess. 351 (1986).

[48] *Id.*

[49] *Id.* This proposal was the prototype for the "subsidiary-group election" provision in the Taxpayer Refund and Relief Act of 1999.

The final version of the 1986 legislation departed from a worldwide fungibility approach, following, in general, the House bill. It provided for the elimination generally of the gross income method and for an interest expense apportionment that treats all members of an affiliated group as one taxpayer. For this purpose, the term "affiliated group" includes possessions corporations, partially following the Senate bill. Anti-abuse regulations further expand the definition of affiliated group for this purpose. These regulations require the application of complex attribution rules and create a special regime for nonconsolidated affiliated group members with losses, increasing substantially the compliance burden of applying the allocation and apportionment rules.[50] Financial institutions that are required to operate independently of other members under state law are excluded from the affiliated group for purposes of interest expense apportionment under the 1986 Act. All such financial institutions within a group are to be treated as one taxpayer for purposes of apportioning interest expense. These special rules for financial institutions also apply to bank holding companies and subsidiaries of financial institutions, and bank holding companies if the subsidiary is predominantly engaged in the active conduct of a banking, financing, or similar business.[51]

The mandatory use of the asset method requires that assets be classified by the source and separate limitation category of the income they produce. This adds substantial complexity as taxpayers must account for assets that produce different types of income at the same time or at different times and must distinguish income-producing from non-income producing assets, not always an easy task. Special rules for classifying different types of stock, tax-exempt assets, and certain other assets also must be applied.[52]

The 1986 Act also provides for the stock basis of each corporation in which the taxpayer owns more than 10 percent to be adjusted by the taxpayer's share of the earnings and profits of that corporation. Thus, foreign earnings are considered, but not foreign interest expense, in apportioning U.S. interest expense under the 1986 Act. These earnings and profits adjustment rules are complex in practice.

In addition, Congress authorized Treasury to provide, in the case of "integrated financial transactions," for the direct allocation of interest expense incurred on funds borrowed to acquire qualified financial assets against the income generated by such assets, if appropriate. The integrated

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[50] Treas. Reg. §1.861-11T.

[51] I.R.C. § 864(e)(5)(B) and (C); Treas. Reg. §1.861-11T(d)(4).

[52] Treas. Reg. §§1.861-9T(g) and (h), -12T, and –8T(d).

financial transactions regulations are complicated but ultimately define narrowly an integrated financial transaction so that the integrated financial transaction exception generally has little impact.[53]

In the legislative history of the 1986 Act, Congress called for a second limited exception for taxpayers to trace interest expense on nonrecourse debt to the income from the related assets, although such a provision was not included in the statute.[54] Congress also stated that it did not intend to preclude Treasury from treating other debt, including recourse debt, as definitely related to a specific property to the extent necessary to preserve the principles of the 1986 legislation.[55] Temporary regulations were promulgated in 1988 (and subsequently amended) that interpret the nonrecourse debt exception. While very complex, these regulations interpret narrowly the exception to the general fungibility rule for nonrecourse indebtedness and thus provide little relief.[56] The nonrecourse indebtedness exception in the regulations is narrower than the exception contained in the 1977 regulations.

A third exception to the general fungibility rule for interest expense, a creature solely of the regulations, is generally referred to as the "CFC netting rule." Proposed regulations, issued in 1987, containing the CFC netting rule required an allocation of all third-party interest expense of a U.S. group first to interest income it received from its CFCs to the extent thereof.[57] The rule was formulated to address the use by U.S. companies of loans of borrowed funds to their CFCs to achieve a more favorable allocation and apportionment of interest expense than would have resulted in the case of direct borrowings by the CFCs.[58] Treasury was concerned taxpayers could use this technique to achieve indirectly the worldwide fungibility approach to interest expense rejected in the 1986 Act conference.

The harshness of the proposed CFC netting rule's mechanics and the belief that it ran counter to the statute provoked an intense controversy. Many argued that the statute's denial of worldwide fungibility was questionable. The 1988 temporary regulations introduced a scaled-back version of the CFC netting rule. The calculation, which is one of the most difficult in the tax law, has the effect of requiring the netting of U.S. interest expense

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[53] Treas. Reg. §1.861-10T(c).

[54] *See, e.g.,* 1986 Bluebook, *supra* note 8, 947.

[55] *Id.*

[56] Treas. Reg. §1.861-10(b).

[57] 1987 Prop. Treas. Reg. §1.861-10(c)(4).

[58] T.D. 8228, 1988-2 C.B. 136.

with interest income received from related CFCs only if the debt-equity ratio of the U.S. group is abnormally high compared to the debt-equity ratio of the related CFCs.[59] In 1992, Treasury finalized 1991 proposed regulations that more narrowly focus the CFC netting rule on abusive situations and provide safe harbor rules.[60] However, the CFC netting rule remains one of the more difficult in the tax law in its current form.

The complexity of the interest expense allocation and apportionment regime is increased further, to cite a few final examples, by special regulatory rules for partnerships, regulations treating as interest expense certain "interest equivalents," and regulations for interest payments within a consolidated group.[61]

9. Loss Allocation

While foreign and U.S.-source income are generally kept separate from one another, and income in the various separate limitations is generally segregated in the same manner, losses complicate the picture. The 1986 Act provides that to the extent foreign losses in one or more limitations do not exceed foreign income in other limitations for the year, the losses are allocated on a proportionate basis among the limitations with income that year. A "separate limitation loss recharacterization rule," also enacted in 1986, applies to the foreign losses apportioned, as just outlined, to other foreign-source income. The separate limitation loss recharacterization rule provides that income subsequently earned in the same limitation as the separate limitation loss will be recharacterized as income of the same limitation reduced by the loss in an earlier year. The separate limitation recharacterization will continue each year until the entire separate limitation loss has been recaptured. This rule resembles the 1976 overall foreign loss (OFL) recapture provision in some respects and, like that rule, increases substantially the compliance burden of U.S. companies that must, for example, track their OFL and separate limitation loss recapture accounts from year to year.

Another source of complexity are special rules applicable under both loss recapture regimes that override nonrecognition rules and that allocate all or a portion of the loss accounts to departing members of consolidated groups.[62]

[59] *Id.*

[60] T.D. 8410, 1992-1 C.B. 245.

[61] Treas. Reg. §§1.861-9T(e), -9T(b) and –11T(d).

[62] I.R.C. §§ 904(f)(1), (f)(3) and (f)(5) and Treas. Reg. §1.1502-9.

The Senate added an amendment to the 1986 House loss rule that is also part of the law today. It provides for U.S. losses to be apportioned to the various separate foreign tax credit limitations on a *pro rata* basis.[63] This amended the prior rule requiring allocation of a U.S. loss among the various foreign tax credit limitations (for interest, DISC and FSC income) based on the foreign taxes paid in each limitation.[64] Congress concluded in 1986 that there was no sound policy basis for this prior allocation method and believed that *pro rata* apportionment of U.S. losses was consistent with its treatment of foreign losses.[65]

Clarifications in the OFL recapture provision of section 904(f) were also made by the 1986 Act. The Conference report for the 1986 Act clarified that foreign-source income earned in a year following the OFL year is characterized as U.S.-source income under section 904(f) only to the extent that the foreign-source income is in the same separate (or overall) foreign tax credit limitation as the previous loss.[66] Thus, OFL accounts must be maintained separately for each separate limitation. However, the Conference report stated that the 50 percent recapture limitation is applied based on aggregate foreign-source income, not solely foreign-source income in the limitation category of the OFL.

Guidance regarding the 1986 Act changes just described was issued in Notice 89-3.[67] A reading of this Notice leaves little doubt that the interaction among the OFL recapture, separate limitation loss recharacterization, U.S. loss allocation, and net operating loss rules is very complex. An absence of examples in Notice 89-3 makes it difficult to apply. Further complexity arises because subpart F also contains loss recharacterization rules (at section 952(c)(2)) and these rules have not been fully coordinated with the separate limitation loss recharacterization rules. Regulations incorporating the 1986 foreign tax credit loss changes have not been issued, although some provisions included in the final section 904(f) regulations issued in 1987 continue to have relevance.

B. Separate Limitations after 1986 Act

Congress continued to create new separate limitations after the 1986 Act that add to the compliance and administrative burden of taxpayers and the

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[63] S. Rep. No. 313, 99th Cong., 2d Sess. 325 (1986); I.R.C. § 904(f)(5)(B).

[64] *See* Rev. Rul. 82-215, 1982-2 C.B. 153, which revoked Rev. Rul. 81-50, 1981-1 C.B. 410, providing for a *pro rata* allocation of the loss among the income baskets.

[65] S. Rep. No. 313, 99th Cong., 2d Sess. 307 (1986).

[66] Conf. Rep. No. 841, 99th Cong., 2d Sess. Vol. I, 591 (1986).

[67] Notice 89-3, 1989-1 C.B. 623.

IRS by requiring that income items be reviewed under an ever-lengthening set of provisions to determine their classification for foreign tax credit limitation purposes.

As discussed in Chapter 3.IX., the Omnibus Budget Reconciliation Act of 1986 denied tax benefits with respect to activities in certain disfavored foreign countries, generally countries with state-sponsored ties to terrorism.[68] Section 901(j) denies foreign tax credits generated from activities in listed countries and imposes a separate limitation on the income from such activities. These rules have given rise to some vexing interpretative issues relating to the transition when countries are added to or deleted from the section 901(j) list.

Also, as previously discussed, the Technical and Miscellaneous Act of 1988 added tax treaty/Code source rule coordination provisions, including section 865(h)(2), which provides that the sourcing rules in the Code for gains from the sale of stock in a foreign corporation or an intangible will yield to treaty foreign sourcing rules at the taxpayer's election.[69] The gains for which foreign sourcing is permitted under this rule are subject to their own separate limitation so that excess foreign tax credits generated outside the treaty country cannot be used solely by reason of the foreign sourcing provided by the treaty. For foreign tax credit limitation purposes, the portion of any dividend from a foreign corporation that is eligible for the dividends received deduction of section 245(a) of the Code generally is treated as U.S.-source income. The 1988 Act also added section 245(a)(10), which provides foreign sourcing instead and eliminates the dividends received deduction at the taxpayer's election where a treaty provides foreign sourcing. Income that is foreign-sourced under this provision, like section 865(h), is subject to a separate limitation. The 1988 Act also created a separate limitation at section 904(g)(10) for dividends, interest, and subpart F income derived from 50 percent U.S.-owned foreign corporations that would be U.S.-sourced under section 904(g), but that a treaty treats as foreign-source. If the taxpayer elects the benefit of such foreign sourcing, a separate limitation applies to the income in question.

Finally, the Revenue Reconciliation Act of 1993 added section 56(g)(4)(c)(iii)(IV), which provides an alternative minimum tax separate limitation for dividends attributable to income that is exempt from tax under section 936 or 30A of the Code.[70]

[68] P.L. 99-509, § 8041(a).

[69] P.L. 100-647, § 1012(d)(8). *See also,* CONF. REP. No. 1104, 100th Cong., 2d Sess. 4 (1988).

[70] P.L. 103-66, § 13227(c)(2).

C. Technical Taxpayer Rule

The foreign tax credit system generally allows the credit to the party that is liable for the foreign tax under the foreign law imposing the tax (the "technical taxpayer rule").[71] The technical taxpayer rule is usually traced back to the Supreme Court decision in *Biddle v. Commissioner.*[72] In *Biddle,* the Supreme Court denied credits for taxes where the taxpayer lacked the legal duty to pay the taxes. In certain situations subsequent to *Biddle,* however, courts have departed from a strict application of the legal liability standard. For example, in *Abbott Laboratories Int'l Co. v. United States,*[73] the court deviated from the strict application of the standard to avoid timing mismatches between the recognition of income and credits for associated foreign taxes. In *Badger Co. v. Commissioner,*[74] the taxpayer was liable for the foreign tax, but no credit was allowed where the taxed amounts were not income of the taxpayer.[75]

Before 1980, the section 901 regulations did not reflect the technical taxpayer rule.[76] In 1980, temporary regulations, which were finalized in 1983, explicitly adopted the rule.[77,78] Current Treas. Reg. § 1.901-2(f) provides that the person by whom tax is considered paid or accrued for purposes of sections 901 and 903 "is the person on whom foreign law imposes legal liability for such tax even if another person (*e.g.*, a withholding agent) remits the tax." The regulation notes that tax is considered paid by the taxpayer "even if another party to a direct or indirect transaction with the taxpayer agrees, as part of the transaction, to assume the taxpayer's foreign tax liability." [79]

The regulations embody a strict version of the technical taxpayer rule. The only exceptions to the rule expressly set forth in the regulations are for certain social security type taxes and taxes on combined income, although there continues to be some debate regarding whether foreign withholding taxes might be creditable absent foreign legal liability in

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[71] Treas. Reg. §1.901-2(f)(1).

[72] 302 U.S. 573 (1938) [hereinafter "*Biddle*"].

[73] 160 F. Supp. 321 (N.D. Ill. 1958), *aff'd per curiam,* 267 F.2d 940 (7th Cir. 1959).

[74] 26 T.C.M. 869 (1967).

[75] *See also, Gleason Works v. Commissioner,* 58 T.C. 464 (1972); *Marsman v. Commissioner,* 216 F.2d 77 (4th Cir. 1954), *cert. Denied,* 348 U.S. 943.

[76] *See* Treas. Reg. §1.901-2(a) (1979). Similar language appeared in article 382 of Regulations 45, issued under the Revenue Act of 1918.

[77] *See* T.D. 7739, 1981-1 C.B. 396. The regulations provided that income tax is paid or accrued by or on behalf of a person if foreign law imposes legal liability for income tax on that person.

[78] *See* T.D. 7918, 1983-2 C.B. 113.

[79] Treas. Reg. § 1.901-2(f).

some instances.[80] The scope of the technical taxpayer rule is illustrated by Example (3) of Treas. Reg. §1.901-2(f)(2)(ii). In Example (3), A is engaged in the construction business in a foreign country. A contracts with the foreign government to build a naval base. The foreign country legally imposes an income tax on A but, under the contractual arrangement with A, the foreign country levying the tax agrees to assume liability for the tax. The example concludes that the tax is considered paid by A.

The technical taxpayer rule is a rule of administrative convenience that provides a relatively high level of certainty regarding entitlement to foreign tax credits. In general, the person on whom foreign law imposes legal liability for a tax can be readily determined, and such person is, from a layman's perspective, normally the best candidate for receiving foreign tax credits. There appears to be no alternative general rule for determining taxpayer status that would provide a comparable level of certainty and compliance ease.[81] Determining the economic incidence of a tax may require a case-by-case analysis and is therefore not practical. Assigning taxpayer status to the recipient of the income taxed has been advocated by some, but requires the additional step of assigning tax to income. Because of the foreign tax credit's double tax avoidance purpose and major impact on the U.S. tax liability of U.S.-based companies, rules such as the technical taxpayer rule that reduce uncertainty and compliance burdens are highly valuable.

The late 1990s witnessed the introduction of two new regimes for policing foreign tax credits. These regimes were layered onto the existing regimes, increasing further the compliance and administrative burdens borne by taxpayers and the IRS. Both of these new regimes essentially create exceptions to the technical taxpayer rule.

In the Taxpayer Relief Act of 1997, Congress enacted a holding period requirement for claiming foreign tax credits with respect to dividends and deemed dividends.[82] This action was prompted by an understandable Congressional concern over trafficking in foreign tax credits. The House Ways and Means Committee report stated:

> Although present law imposes a holding period requirement for the dividends-received deduction for a

[80] *See* Treas. Reg. §§1.901-2(f)(1) (last sentence) and -2(f)(3); J.M. Peaslee, *Economic Substance Test Abused: Notice 98-5 and the Foreign Law Taxpayer Rule,* 98 TAX NOTES 79-87 (Apr. 6, 1998). Under the temporary regulations, there was a more liberal rule for certain withholding taxes. *See* Treas. Reg. § 4.901-2(g)(3) (1980).

[81] A. Fischl, *Editorial on Notice 98-5,* 9 J. INT'L TAX. (No. 3) 3 (1998).

[82] P.L. 105-34, § 1053(a).

> corporate shareholder (sec. 246), there is no similar holding period for foreign tax credits with respect to dividends. As a result, some U.S. persons have engaged in tax-motivated transactions designed to transfer foreign tax credits from persons that are unable to benefit from such credits (such as a tax-exempt entity or a taxpayer whose use of foreign tax credit is prevented by the limitation) to persons that can use such credits. These transactions sometimes involve a short-term transfer of ownership of dividend-paying shares. Other transactions involve the use of derivatives to allow a person that cannot benefit from the foreign tax credits with respect to a dividend to retain the economic benefit of the dividend while another person receives the foreign tax credit benefits.[83]

To address these issues, the 1997 provisions condition allowance of the credit on meeting the minimum holding period and related payment tests that apply to the dividends received deduction under section 246. The new holding period requirement in section 901(k) can be a trap for the unwary, for example, when in-house reorganizations occur and a company pays a dividend while holding a transitory position in the corporate structure.

The second new regime introduced in recent years to police foreign tax credits is Notice 98-5.[84] Notice 98-5 announces the IRS's intention to issue regulations that will deny foreign tax credits in abusive arrangements involving two categories of transactions. The two categories of transactions are: (i) acquisitions of assets that generate an income stream subject to foreign gross basis taxes (*i.e.,* withholding taxes); and (ii) cross-border tax arbitrage transactions that take advantage of the differences in the U.S. and foreign treatment of an item that permit the effective duplication of tax benefits. A transaction described in one of these two categories is considered abusive if the expected economic profit is "insubstantial" compared to the foreign tax credits generated.

Notice 98-5's release generally was prompted by foreign tax credit-generating transactions of questionable merit. The IRS's attack on these transactions is understandable, but the methodology employed by the IRS in Notice 98-5 creates problems for taxpayers not engaged in abusive transactions. For example, the Notice states that the regulations will emphasize an

[83] H.R. REP. No. 148, 105th Cong., 1st Sess. 545 (1997).

[84] I.R.B. 1998-3, 49 (January 19, 1998).

objective approach to calculating expected economic profit and credits and will require that the determination of expected economic profit reflect the likelihood of realizing both potential gains and potential losses. However, it is understood that acceptable ratios of expected economic profit to foreign tax credits likely will not be published in the regulations, leaving taxpayers in a state of considerable uncertainty. Expected profit will be determined without regard to executory financial contracts that do not represent a real economic investment or potential for profit. The Notice states that reasonably expected economic profit would be determined by taking into account foreign tax consequences, but not U.S. tax consequences.

The Notice also indicates that the test will be applied to "discrete arrangements" that may be defined by batching together a series of related transactions or treating portions of a single transaction as separate arrangements. The vagueness of this "discrete arrangement" standard will likely create further uncertainty for taxpayers. Expected economic profits will be determined by taking into account expenses associated with an arrangement without regard to whether the expenses are deductible.[85]

[85] The Notice illustrates the withholding tax transactions to which it applies with three examples, the first and second of which are similar in principle. The second example involves a U.S. party that purchases a foreign bond with a principal amount of $1,000 paying annual interest of $100, subject to a 4.9 percent withholding tax, for $1,096 on the day before an annual coupon payment date. On the next day, the purchaser receives $95.10 (the coupon of $100 less tax of $4.90). Five days after the purchase, the U.S. party sells the bond for $1,001.05 but claims a credit of $4.90 with an expected economic profit of only $0.15. Since the profit is insubstantial in relation to the credits, the Notice considers the transaction abusive.

The third example differs from the first two in that the holding of the property generating the foreign tax credits is not short-term. It involves an investor that cannot benefit from foreign tax credits but wishes to acquire a foreign bond having a principal amount of $1,000 that provides annual interest payments of $100, subject to a 4.9 percent withholding tax. Instead of buying the bond, it invests its $1,000 elsewhere and enters into a swap with an unrelated U.S. party that can utilize the foreign tax credit. The U.S. party purchases the bond and incurs $1,000 of debt, paying interest at a rate of LIBOR to finance its position in the bond. Since the U.S. party receives net interest on the bond (after the withholding tax) of $95.10 and is required to pay $96 to the investor, and the other payments on the swap match actual costs or profits earned by the U.S. party, the U.S. party expects an economic loss, so the Notice considers the transaction abusive.

The Notice illustrates abusive transactions involving tax arbitrage with two examples. Both examples involve hybrid instruments and one involves a hybrid entity as well. However, it is difficult to discern from these examples which other tax arbitrage transactions would come within the scope of the Notice.

The first example involves a U.S. investor that establishes a corporation in a foreign jurisdiction and capitalizes it with $10 of equity. The company borrows $90 from a foreign investor and uses its capital of $100 to buy a fixed income investment (either a third-party obligation or a loan to the U.S. investor) producing annual income of $10. The $90 borrowing is treated as equity under local law, with the result that no deduction is allowed to the company for interest expense and the foreign investor is entitled to exclude income it receives from its own taxable income under a regime for avoiding double taxation of corporate dividends. Because of this benefit, the foreign investor is willing to receive interest at a rate of only 7.5 percent (as compared with the taxable rate of closer to 10 percent). The earnings of the corporation are subject to a 30 percent tax, with the result that the corporation has earnings after foreign taxes and interest expense of $0.25 per annum ($10 less $3 of taxes and $6.75 of interest expense). That amount is 8.33 percent of the $3 of foreign tax credit claimed, which is considered insubstantial. The second example involves a U.S. party that forms a foreign company in Country X with capital of $100 of equity and a loan of $900 from a Country X investor bearing interest at a rate of 8 percent. The $1,000

Credits denied under the Notice to the technical taxpayer apparently are not permitted to other parties.

In Notice 98-5, the IRS also noted that it would consider issuing guidance to attack other abuses in the foreign tax credit area. The Notice states that the IRS may address transactions involving high withholding tax interest and other gross basis taxes. In addition, the IRS may issue guidance to deal with concerns about credits claimed with respect to some hedging transactions. The IRS is also considering new guidance on hybrid entity and other structures that create a significant mismatch between the timing of income inclusions and credits. For such transactions, the Treasury and IRS are considering deferring the tax credits until the taxpayer recognizes income or accelerating the income recognition to the time at which the credits are allowed by allocating the credits or income under section 482. The IRS thus appears to be reconsidering its litigating position in *Abbot Laboratories Int'l Co. v. United States,*[86] which was essentially abandoned in the final section 901 regulations, with their strict formulation of the technical taxpayer rule.

In *Compaq Computer Corp. v. Commissioner,*[87] Compaq had entered into a transaction designed to help reduce the tax impact of a large long-term capital gain. The transaction was the type targeted by section 901(k) in 1997.[88]

of assets are used to buy preferred stock of an unrelated party in Country Y that pay dividends of 10 percent subject to a Country Y 25 percent withholding tax. Under Country X tax law, the foreign company is classified as a partnership and the loan is treated as equity. The Country X tax law allows the lender to claim a foreign tax credit for 90 percent of the Country Y withholding tax. The foreign company is also a transparent entity for U.S. tax purposes. Further, for those purposes, the loan is recognized as debt. As a result, the U.S party is considered to own all of the equity of the foreign company and claims a credit for 100 percent of the Country Y withholding tax, thereby resulting in a duplication of tax benefits. The annual profit from the transaction of $3 ($100 less $72 interest expense on the loan and $25 withholding tax liability) is 12 percent of the credits of $25, which is considered insubstantial.

[86] 160 F. Supp. 321 (N.D. Ill. 1958).

[87] 113 T.C. No. 17 (September 21, 1999).

[88] That transaction was completed in the same taxable year in which the gain arose and was executed as follows:

• Compaq purchased ADR shares of a Dutch company and sold those shares in the same hour. The ADR sales contracts had settlement terms such that Compaq owned the shares for the record date of dividends paid by the Dutch company.

• The Dutch company paid a dividend of $22.5 million to Compaq, but deducted $3.4 million (15 percent) of Dutch withholding tax. Actual cash received by Compaq was $19.2 million.

• Compaq claimed the following tax effects from the transaction: dividend income of $22.5 million (gross dividend), foreign tax credit of $3.4 million (withheld amount), and a short-term capital loss of $20.6 million (loss on sale).

One of the issues before the Tax Court was whether Compaq had a tax savings or tax benefit purpose in entering into this transaction. Compaq claimed that the transaction increased its taxable income by $1.9 million (gross dividend less loss on sale), and therefore its U.S. tax liability increased. Compaq further argued that, to find a tax benefit purpose in this transaction, the court would have to find that any transaction had a tax benefit purpose when that transaction increased overall tax liability but reduced U.S. tax liability.

The court disagreed, finding that the transaction yielded no economic profit when the benefit conferred by the U.S. tax rules was ignored. From the court's perspective, Compaq did not receive

The Tax Court in *Compaq Computer* was the first court to apply the economic substance/business purpose requirement, as formulated in tax shelter cases, to disallow foreign tax credits and, in so doing, lent support to the IRS's similar approach in Notice 98-5. The *Compaq Computer* decision is currently on appeal to the U.S. Court of Appeals for the Fifth Circuit. More recently, in another case involving similar facts, the U.S. Court of Appeals for the Eighth Circuit sided with the taxpayer rather than the IRS and reinstated the foreign tax credits denied below.[89]

While issued in response to some real abuses, Notice 98-5 unfortunately undermines the benefits of the technical taxpayer rule. The Notice's lack of a routine business transaction exception means many taxpayers will have to test common transactions under the Notice's economic profit test. That test will often not be easy to apply in practice because, among other reasons, of the difficulty of defining a "transaction" under the Notice. Also, it is understood that the IRS regulations implementing the Notice will not provide safe harbors, *i.e.*, acceptable ratios of foreign tax credit to economic profit. Other interpretative difficulties under Notice 98-5 are discussed in the final chapter of this report. As indicated there, a better approach than introducing a new set of requirements for claiming a foreign tax credit would be to adapt existing tools, such as the separate foreign tax credit limitations, to address the abuses with which Notice 98-5 is concerned.

D. Foreign Tax Credit Carryforwards and Carrybacks

Treasury and the IRS have acknowledged from time to time that the foreign tax credit rules are complex to administer, sometimes as a basis for advocating changes to the system. A final example involving the complexity issue can be drawn from the debate over the appropriate carryforward and carryback periods for the foreign tax credit. For example, in 1997, Treasury advocated a reduction in the foreign tax credit carryback period to one year and an extension of the carryforward period to seven years.[90] It has been argued

$1.9 million, but rather had a loss of $1.5 million, calculated by deducting the $3.4 million of withholding tax from the $1.9 million. Counting the foreign taxes as a cost of the transaction, the court found that the transaction yielded an economic loss prior to the benefits available from U.S. tax provisions (namely, the ability to use the foreign tax credits). The Tax Court accepted the IRS's argument that the taxpayer should be denied the credit if the transaction lacked both economic substance and business purpose. The court relied on tax shelter cases such as *ACM Partnership v. Commissioner,* 157 F.3d 231 (3d Cir. 1998), and *UPS of America v. Commissioner,* T.C. Memo 1999-268, as the IRS had urged it to do.

[89] *See IES Industries v. United States,* 2001-2 U.S.T.C. ¶ 50,471 (8th. Cir. 2001) *aff'ing in part and rev'ing in part* 84 A.F.T.R. 2d 99-6445 (N.D. Iowa 1999).

[90] C. McClure & G. B. Lanning, *Proposed U.S. Legislation Dealing with Taxation of Foreign Income Revisited—Again,* 17 Tax Notes Int'l 1053, 1054 (October 5, 1998) [hereinafter "McClure & Lanning"]. Treasury's recommendation was included in the Administration's Fiscal Year 1998 Budget

that the carryback of foreign tax credits creates complexity and greater administrative burdens than the carryforward of foreign tax credits.[91] Shortening the carryback period and lengthening the carryforward period could reduce some of this complexity, though at the cost of taxpayer loss of the time value of money.[92]

III. Role of Revenue Constraints in Shaping Current Credit Regime

Major features of the current foreign tax credit regime are the product, at least in part, of Congressional efforts to raise revenue generally, to achieve precise revenue targets for particular foreign tax credit-related rules, or to avoid increasing the federal budget deficit. Sound tax policy generally has taken a back seat where revenue goals were the primary driver. This problem was particularly serious in the 1980s in light of that decade's large budget deficits and has left the Code with a number of flawed foreign tax credit rules.

During the early 1980s, for example, foreign operations of major oil companies received attention from lawmakers due to the persistent anti-foreign oil sentiment linked to the price hikes of the 1970s. There was also added pressure in 1982 to enact revenue-raising measures to reduce the mounting federal deficit. A combination of these influences culminated in the enactment in the Tax Equity and Fiscal Responsibility Act of 1982 of amendments to section 907 that made stricter already strict rules limiting foreign tax credits with respect to foreign oil and gas income. As discussed in V., below, these rules were arguably redundant when enacted, owing to the existence of foreign tax credit regulations addressing very similar issues.

The 1986 Act legislative history frankly acknowledged that Act's focus on revenue-raising in the international area. The 1986 Bluebook states: "Overall, the Act is estimated to increase substantially the U.S. tax on the

Proposal, Joint Committee on Taxation, Description and Analysis of Certain Revenue Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal, JCS-10-97 (April 16, 1997) and in the Senate version of the 1997 Act, but was not included in the final bill. In 1999, the Senate again passed legislation decreasing the carryback to one year and increasing the carryforward to seven years. § 501, S. 331, Work Incentives Improvement Act of 1999 (1999); § 202, S. 1792, Tax Relief Extension Act of 1999 (1999); § 801, S.1344, Patients' Bill of Rights Plus Act (1999). The same carry-over provision was included in the vetoed Taxpayer Refund and Relief Act of 1999.

[91] *Export Source Coalition's Testimony Against Limit on Export Source Rules at Ways and Means Subcommittee Hearings,* 93 Tax Notes 166-169 (September 21, 1993).

[92] *Id.*

aggregate U.S.-source income of U.S. corporations, but not to increase significantly the U.S. tax on the aggregate foreign-source income of U.S. corporations. Reducing cross-crediting opportunities (along with some of the Act's other foreign tax provisions) attenuates this disparity somewhat."[93] The 1986 Act was designed to increase taxes on corporations in the aggregate while lowering them on individuals in the aggregate without increasing the budget deficit.[94] The separate limitation for noncontrolled section 902 corporations is an example of a 1986 Act international corporate provision thought widely to have been revenue-driven, at least in part.

Another example is the interest expense allocation and apportionment rules. The Senate-passed version of the 1986 bill provided for apportionment of interest expense based on an expanded affiliated group that included both foreign corporations that would be eligible to consolidate were they not foreign and possessions corporations that would be eligible to consolidate absent statutory prohibition.[95] The Senate version of the bill, unlike the House version, thus considered foreign-borne interest expense in apportioning the interest deduction of the U.S. members of the group in order to adhere more closely to the worldwide fungibility approach of the interest expense apportionment amendment.[96] The final version of the 1986 legislation departed from a consistent worldwide fungibility approach, following, in general, the House bill.

Opponents took issue with this approach because it failed to take into account interest expense incurred by foreign affiliates. Pursuant to a fungibility theory, opponents noted that interest incurred by foreign affiliates may help generate U.S.-source income and should be available for apportionment against U.S.-source income. In addition, this approach did not recognize the possibility that a foreign affiliate could bear an appropriate amount of interest expense directly, before any apportionment of interest paid by its U.S. affiliates.[97] It is widely thought that the worldwide fungibility approach was rejected in conference in 1986 primarily on revenue grounds.[98] The Taxpayer Refund and Relief Act of 1999 passed by Congress, but vetoed by the

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[93] 1986 Bluebook, *supra* note 8, 862.

[94] *See, e.g.*, J. Birnbaum and A. Murray, Showdown at Gucci Gulch—Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform 260-261 (Vintage Books 1987); 1986 Bluebook, *supra* note 8, 1378.

[95] S. Rep. No. 313, 99th Cong., 2d Sess. 351 (1986).

[96] *Id.*

[97] *Id.*

[98] Sellers and T. Tuerff, *Taking Advantage of Exceptions to Asset-Based Apportionment,* 1 J. Int'l Tax'n 261 (January/February 1991).

President, included a worldwide fungibility interest expense apportionment provision[99] intended to address issues left by the 1986 Act.

The Congressional desire to promote domestic research and experimentation (R&E) and the conflicting need for tax revenues have influenced the tax treatment of R&E expenses since proposed regulations addressing the allocation and apportionment of R&E expenses were issued in 1973.[100] Congress and Treasury were, for many years, unable to agree on the proper tax policy in this area. In 1977, Treasury issued regulations that were the culmination of a comprehensive effort to prescribe an appropriate method.[101] Proposed regulations had been issued in 1973 that required R&E expense to be apportioned between foreign and U.S.-source income within a class of income based on sales. This generally represented a change from the practices of taxpayers up until that time. Most taxpayers either had not apportioned R&E expenses to foreign-source income or had apportioned such expenses between foreign and U.S.-source income based on gross income.[102] The 1973 proposed regulations were withdrawn and new proposed regulations were issued in 1976 after extensive modifications responding to taxpayer comments. These regulations were finalized with no substantial modifications in 1977.

The 1977 regulations provided that R&E expenses are "ordinarily" considered related to all income connected with the product categories of a taxpayer.[103] A taxpayer was required to segregate all income into specific broad product categories (*i.e.*, product categories based on the two-digit classifications contained in the Standard Industrial Classification system) and then match R&E expenses with such income using the methods detailed in the regulations. An exception was provided by the regulations for government mandated R&E expenses. Any R&E expenses associated with legal requirements imposed by a political entity could be allocated directly to gross income arising in a particular geographic area. After

[99] H.R. 2488, § 901 (August 1999). The provision would allow a taxpayer to elect to apportion interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis. A "worldwide affiliated group" is defined as all corporations in an affiliated group (as that term is defined under current law for interest expense allocation purposes), as well as any foreign corporations with respect to which domestic members of the affiliated group own stock meeting the ownership requirements for treatment as CFCs.

[100] Staff of Joint Committee on Taxation, Description of Proposals Relating to Research and Development Incentive Act of 1987 (S. 58) and Allocation of R&D Expenses to U.S. and Foreign Income (S.716), JCS-6-87, 37-40 (April 2, 1987).

[101] T.D. 7456, 1977-1 C.B. 200.

[102] *See* Interaction Between U.S. Tax Policy and Domestic Research Development Hearing on S. 58 and S. 716 Before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, 100th Cong., 1st Sess. 84 (1987).

[103] Treas. Reg. §1.861-8(e)(3) (1977).

consideration of any government mandated R&E expenses, a specified percentage (*i.e.*, 50 percent for tax years beginning during 1977, 40 percent for tax years beginning during 1978, and 30 percent for all subsequent tax years) of R&E expenses was then apportioned to the geographic location where more than 50 percent of all the R&E expenses were incurred.[104] Any R&E expenses remaining after this exclusive geographic apportionment were then generally apportioned based on sales.[105]

Taxpayer criticism of the 1977 regulations led Congress to enact several temporary suspensions of, or moratoria on, those regulations. These moratoria were favorable to taxpayers with excess foreign tax credits because they permitted 100 percent of U.S.-conducted R&E deductions to be allocated and apportioned to U.S.-source income. The Tax Reform Act of 1986 allowed the moratorium on the application of the R&E allocation rules to expire.[106] Congress at that time enacted three temporary modifications to the 1977 regulations, intending these liberalizing modifications to provide an additional tax incentive to conduct research in the United States while the question of whether any additional permanent incentives were required was studied.[107]

In 1987, the Reagan Administration testified in favor of a proposal that would have permanently enacted the 1986 provisions and increased the exclusive geographic apportionment from 50 to 67 percent. The 67 percent cut-off was a pure "plug" number utilized to achieve a precise revenue target, having no relationship to tax policy. The proposal reflected the tentative agreement of House and Senate sponsors of moratorium legislation, the Treasury, and affected companies, but ultimately was not included in the Omnibus Reconciliation Act of 1987. However, beginning with the Technical and Miscellaneous Revenue Act of 1988, Congress passed a series of provi-

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[104] A larger percentage than the mandated percentage could be used if a taxpayer established that a larger percentage was warranted.

[105] Treas. Reg. §1.861-8(e)(3) (1977). Under the sales method, R&E expenses within each product category were apportioned between foreign and U.S.-source income based on sales. In addition, an optional gross income method for the apportionment of the remaining R&E expenses was available, subject to certain limitations. This method was used to apportion the portion of the R&E expenses remaining after the apportionment of expenses related to qualifying government-mandated research. No exclusive geographic apportionment was available under the regulations if the optional gross income method was used. *Id.*

[106] Tax Reform Act of 1986, P.L. 99-514, § 1216.

[107] The first modification increased the percentage of R&E expenses that could be directly allocated to the geographic location where more than 50 percent of a taxpayer's R&E expenses were incurred from 30 to 50 percent. The second modification allowed for R&E expenses remaining after any government mandated research apportionment and after the 50 percent geographic apportionment, to be apportioned based on either sales or gross income. The third modification allowed for the temporary suspension of the special limitations associated with the optional gross income method. 1986 Bluebook, *supra* note 8, 956.

sions temporarily enacting, and then extending, a modified version of the 1987 proposal.[108] These provisions were embodied in section 864(f).

The foreign tax credit carryforward and carryback provisions also have been shaped in part by revenue concerns. Congress enacted the foreign tax credit carryforward and carryback provision as part of the Technical Amendments Act of 1958.[109] The two-year carryback and five-year carryforward of excess foreign tax credits adopted in 1958 is unchanged today, in section 904(c). Since 1958, numerous proposals have been made to expand the carryback and carryforward periods, in some cases tying the changes to those for net operating losses.[110] Treasury has objected to these proposals on, among other grounds, the ground of lost revenue.[111]

Finally, many proposals have been advanced for an overall domestic loss recapture rule that mirrors the OFL recapture rule of section 904(f), but revenue considerations have thwarted their enactment. While domestic loss recapture would add to the foreign tax credit limitation's complexity, there is little policy disagreement that current year reductions in foreign-source income by U.S. losses should later be reversed just as current year reductions in U.S.-source income by foreign losses are later reversed under section 904(f). Domestic loss recapture would ensure that foreign as well as U.S.-source income is, over time, computed separately, that is, without reduction by losses in the other category.

[108] Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, § 4009. *See* Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, § 7111; Revenue Reconciliation Act of 1990 P.L. 101-508, § 11401; and The Tax Extension Act of 1991 P.L. 102-227, § 101.

[109] Technical Amendments Act of 1958, P.L. 85-866. The House included the provision in the legislation to prevent the double taxation that could occur as a result of timing differences in the recognition of income in the United States and in various foreign jurisdictions. The provision was seen as a mechanism for matching economically the income and deductions with the foreign tax credits. H.R. REP. No. 775, 85th Cong., 1st Sess. 82 (1957).

[110] *See, e.g.,* S. 1584, The Foreign Tax Credit Conformity Act of 1983 (1983) (15-year carryforward); H.R. 5270, Foreign Income Tax Rationalization and Simplification Act of 1992 (1992) (three-year carryback and 15-year carryforward); H.R. 1690 (1995) (15-year carryforward); H.R. 4173, The International Tax Simplification for American Competitiveness Act (1998) (10-year carryforward). Other proposals have called for a change in the mechanics of the carryover rules, for example, a first-in first-out ordering rule for the utilization of foreign tax credits. *See e.g.,* S. 1584, The Foreign Tax Credit Conformity Act of 1983 (1983).

[111] Treasury has also stated the belief that an extension of the carryforward period would allow for inappropriate averaging of high- and low-taxed foreign income. McClure & Lanning, *supra* note 90. Treasury has expressed the view that a significantly longer carryforward (or carryback) would permit foreign taxes paid on one year's income to offset pre-credit U.S. tax on another year's income (after timing differences in reporting income are accounted for), and thus would controvert the matching of income to taxes. STAFF OF JOINT COMMITTEE ON TAXATION, TAX REFORM PROPOSALS: TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS, JCS-25-85, 42 (July 18, 1985). Treasury has further stated that if the length of the current carryforward period gives rise to mismatching of this type, then extending the carryforward period would merely increase the incidence of the mismatching. STAFF OF JOINT COMMITTEE ON TAXATION, TAX REFORM PROPOSALS: TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS, JCS-25-85, 42 (July 18, 1985).

In 1983, for example, a Senate bill included a domestic loss recapture provision that mirrored the foreign loss recapture provision.[112] To the extent that foreign-source income had been offset by a domestic loss, domestic-source income would be recharacterized as foreign-source income, in a tax year subsequent to the loss year, in an amount equal to the lesser of 50 percent of domestic taxable income or the amount of the overall domestic loss. The bill was proposed to address the situation in which a taxpayer earns foreign-source income and pays foreign tax on that income, but because of domestic-source losses that offset all or a part of the taxpayer's foreign income, the foreign tax credits are not fully utilized and must be carried back or carried forward. The problem was illustrated as follows:[113]

	Current Law		Proposal	
	Year 1	Year 2	Year 1	Year 2
Foreign-Source Taxable Income	100	100	100	100
Foreign Tax Paid	46	46	46	46
U.S.-Source Taxable Income	(100)	100	(100)	100
Worldwide Taxable Income	0	200	0	200
U.S. Tax	0	92	0	92
Foreign Tax Credit	0	46	0	92
Excess Foreign Tax Credit	46	0	46	0
Total U.S. Tax Paid	0	46	0	0
Foreign Tax Credit Carryover	46	46	46	0

Treasury did not support the 1983 provision, primarily because of the revenue loss associated with its implementation.[114] However, in 1985, the Administration proposed an identical overall domestic loss rule in its budget, reversing its earlier opposition to domestic loss recapture.[115]

In 1987, the ALI Study called for a recapture rule for domestic losses mirroring the foreign loss recapture rule of section 904(f).[116]

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[112] S. 1584, The Foreign Tax Credit Conformity Act of 1983 (1983).

[113] Hearing Before the Subcommittee on Taxation and Debt Management of the Committee on Finance on S. 120, S. 1397, S. 1584, S. 1814, S. 1815, and S. 1826 (September 26, 1983): statement of Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury 76.

[114] Due to the economic recession, many companies had significant domestic losses at this time.

[115] Staff of Joint Committee on Taxation, Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers, JCS-25-85, 75-6 (July 18, 1985).

[116] ALI Study, *supra* note 1, 372-73.

In 1992, the House proposed H.R. 5270, which included a domestic loss recapture provision.[117] Assistant Treasury Secretary (Tax Policy) Goldberg, testifying before the House Ways and Means Committee on the bill, indicated that, as a policy matter, it could be appropriate to provide for symmetrical treatment of overall domestic losses and OFLs. The 1993 Treasury Report on International Tax Reform included an identical overall domestic loss recapture proposal.[118] In 1995, an overall domestic loss recapture provision was again proposed in Congress.[119] More recently, overall domestic loss recapture provisions were included in 1999 tax legislation passed by Congress, but vetoed by the President.[120] Observers agree that the overriding reason domestic loss recapture had not been enacted prior to the 1999 legislation was its revenue cost.

IV. Repeated Reformulation of Foreign Tax Credit Limitation

Since its enactment in 1921, the foreign tax credit limitation has been reformulated numerous times. Most, if not all, possible permutations and combinations of the per-country and overall limitation have been tried, and some have been tried more than once. More recently, a variety of separate and special foreign tax limitations have been added to the credit landscape. These changes have gone beyond mere tinkering. The ALI Study concludes that "there simply has been no consistent Congressional view of the policy underlying limitation issues."[121] The significant inconsistency over the years, in Congressional actions and in the positions of Administrations of both parties, in formulating the limitation and in articulating the reasons for the various changes, and the lack of consensus on the proper limitation approach, suggest the absence of any theoretically "correct" limitation formulation.

Before the Tax Reform Act of 1986 made separate foreign tax credit limitations important, the overall and per-country foreign tax credit limitations were the principal foreign tax credit limitation types in place. At different times from 1921 through 1986, four variations on the overall and per-country limitations were in effect: the overall limitation alone; the

[117] Staff of Joint Committee on Taxation, Explanation of H.R. 5270: Foreign Income Tax Rationalization and Simplification Act of 1992, JCS-11-92 (May 29, 1992).

[118] International Tax Reform, An Interim Report, Department of the Treasury (January 1993).

[119] *See* H.R. 1690; Staff of Joint Committee on Taxation, Description of Miscellaneous Tax Proposals, JCS-19-95 (July 10, 1995).

[120] *See* H.R. 2488, The Taxpayer Refund and Relief Act of 1999, § 905 (August 1999).

[121] ALI Study, *supra* note 1, 318.

per-country limitation alone; the lesser of the two; and the per-country limitation with an election to apply the overall limitation. The discussion in preceding chapters highlights some of the competing concerns Congress had in shifting from one variation to the next. It should be noted that the per-country limitation never provided "look-through" rules, comparable to those adopted in 1986, to maintain the country-by-country character of income as it flowed up through a foreign holding company. A U.S. taxpayer could effectively obtain an overall limitation through self-help, by placing subsidiaries operating in various foreign countries beneath a single foreign holding owned by the U.S. taxpayer.[122]

While the 1986 Act rejected the per-country limitation, it did not embrace the overall limitation without reservations. It added a variety of new separate limitations, those for passive income, high withholding tax interest income, financial services income, shipping income, and dividends from noncontrolled section 902 corporations.[123] These five separate limitations joined three others already in existence and were joined, in turn, by additional separate limitations in later legislation as Congress broadened its conception of a separate limitation's purpose. Most of the separate limitations group income by the activity that generates it, but there are exceptions, for example, the separate limitations that limit the benefit of treaty source rules. One of the 1986 Act separate limitations, that for dividends from noncontrolled section 902 corporations, has since been repealed effective for 2003.

Further support for the view that there is no theoretically correct foreign tax credit limitation can be found in the history of the foreign tax credit rules for oil and gas companies, which is described principally in V., below. These rules have undergone numerous changes and reversals of changes. Most recently, the Clinton Administration proposed repealing current section 907(a) and replacing it with a separate foreign tax credit limitation for foreign extraction income and other foreign oil-related income.[124] This proposal would have brought the law in this area nearly full circle by essentially reinstating the 1975 section 907 separate limitation rule repealed in 1982 and replaced with current section 907.

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[122] *See* I.R.C. § 904(d)(3); ALI Study, *supra* note 1, 325-326.

[123] *See* Conf. Rep. No. 841, 99th Cong., 2d Sess. Vol. II 564-72 (1986).

[124] Staff of Joint Committee on Taxation, Description and Revenue Estimates for Revenue Provisions in President's Fiscal Year 1998 Budget Proposal, JCS-10-97, 60-1 (April 16, 1997); Staff of Joint Committee on Taxation, Description and Revenue Estimates for Revenue Provisions in President's Fiscal Year 1999 Budget Proposal, JCS-4-98, 187-90 (February 24, 1998); Treasury Department, General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals 212 (2000).

The opposite of an overall limitation is not a per-country, separate, or special limitation, but a "per-item" limitation. A per-item limitation is a separate limitation for each foreign income item, which could mean thousands of separate limitations for each company. A "per-item" limitation would minimize averaging. However, it has never been seriously considered for adoption. One reason is its impracticality. Compliance and administration would be very difficult at best and impossible at worst under a per-item system. Another reason is that a per-item limitation would be inconsistent with the integrated business model for overseas operations that Congress has generally favored in the limitation area.[125]

Unfortunately, choosing between an overall, per-country, separate and per-item approach is not made much easier by focusing on the foreign tax credit's basic purpose. The basic purpose of the credit is to reduce or eliminate international double taxation of foreign-source income, but there is no consensus on how foreign-source income should be defined for this purpose. For instance, if foreign-source income were properly defined for this purpose as all foreign-source income of the taxpayer in the aggregate, then an overall limitation would seem most appropriate. An example illustrates the point: assume a taxpayer earns 100 in Country A and 100 in Country B. Country A's tax rate is 50 percent and Country B's tax rate is 30 percent. The foreign tax on the taxpayer's 200 of total foreign-source income is therefore 80, reflecting an effective foreign tax rate of 40 percent. Because the 80 of foreign tax exceeds the pre-credit U.S. tax of 70 on the 200 of income, international double taxation would result if residual U.S. tax were imposed on this 200 of income if this 200 is viewed in the aggregate. Under the overall limitation, such residual U.S. taxation is avoided and therefore the overall limitation seems most appropriate if foreign-source income is properly defined as all foreign-source income in the aggregate. A per-country limitation, by contrast, would result in the collection of 5 of residual U.S. tax on the Country B income.

If foreign-source income were properly defined country-by-country, activity-by-activity, or item-by-item, then the other limitation formulations would seem most appropriate. In the above example, the Country B income of 100, viewed in isolation on a country-by-country basis, would not be double taxed if 5 of U.S. tax were imposed on it because it bears only 30 of foreign tax.

[125] *See generally* ALI Study, *supra* note 1, 318-321.

There is an unsatisfying circularity, then, to the search for a theoretically "correct" limitation formulation. This appears to have led the ALI Study drafters to eschew such a quest in favor of a practical, cost/benefit approach that weighs the tax legislative objectives of a particular limitation formulation against the compliance and administrative difficulties of that formulation.[126] We believe this type of approach, although necessarily subjective, is most sound in evaluating the current foreign tax credit limitation rules and possible substitutes.

V. Redundancy in Foreign Tax Credit Rules

Congress has tended to enact new international tax rules somewhat more enthusiastically than it has eliminated earlier, overlapping rules. It may not seem prudent to some Congressional staffers to recommend repeal of regimes that predate their Hill experience, the repeal of which might produce results not fully appreciated. An example of this phenomenon is the Code's inclusion of three different sets of anti-deferral rules for foreign corporations—subpart F, the FPHC rules, and the PFIC rules. Congressional reluctance to repeal earlier rules has also led to some redundancy in the foreign tax credit rules.

The section 907 rules for oil and gas foreign tax credits are a case study of the problem. To see their redundancy, it is useful to review the history of the foreign tax credit rules for oil and gas companies.

In 1950, in response to Saudi Arabia's demands for higher revenues from its oil concessions, the State Department, through the National Security Council, recommended, on national security grounds, that the Saudi Arabian income tax be considered fully creditable against U.S. income taxes. Treasury implemented this recommendation in Rev. Rul. 55-296.[127] Primarily based on Rev. Rul. 55-296, foreign taxes on oil income were generally treated as fully creditable for U.S. foreign tax credit purposes until 1976.[128]

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[126] *Id,*, 332.

[127] 1955-1 C.B. 385. In 1950, a Venezuelan tax on foreign petroleum companies was also ruled creditable, I.T. 4038, 1950-2 C.B. 54.

[128] Staff of Joint Committee on Taxation, Explanation of Foreign Tax Credit Rules Applicable to Petroleum Income and Description of Administration Proposal, JCS-26-79, 11-12 (June 18, 1979).

Two years after the publication of Rev. Rul. 55-296, the Staff of the Joint Committee on Taxation reviewed the basis for the 1955 ruling[129] and concluded that it represented a proper interpretation of the law that allowed foreign taxes to be creditable if based on the realized proceeds of business operations.[130] Up until 1957, posted price systems, which were the mechanism for payment of taxes to the majority of oil-producing countries, generally tracked market prices, and thus foreign taxes could be considered based on "realized proceeds."[131] However, after 1957, posted prices began to diverge from market prices as the world oil market declined and foreign taxes calculated using the posted price system could no longer be considered reliably based on "realized proceeds."[132] Despite the changes in the oil market, the IRS continued to issue revenue rulings from 1957 to 1976 that allowed foreign taxes imposed under a posted price system to be fully creditable.[133]

Congress considered legislation in 1969 to prevent the use of foreign tax credits for high rate foreign taxes on oil and gas extraction income from offsetting U.S. tax on other income.[134] The House-passed version of the Tax Reform Act of 1969 provided for a separate limitation in computing the foreign tax credit available to offset U.S. tax on foreign mineral income from sources within a particular foreign country. Any excess foreign tax credits resulting from application of this separate limitation could not be used to offset the U.S. tax on other income from that country or on any income from other foreign countries.

The impetus for the 1969 House proposal was concern that high rate extraction taxes were in substance partially royalty payments for the right to extract minerals and that the ability to credit such taxes against U.S. income provided a financial boon to the oil industry.[135] As a result of the oil producing countries' efforts to collect increasing amounts of revenue from extraction activities, payments denominated as taxes were often much higher than the U.S. tax on such income, allowing taxpayers to claim a larger foreign tax credit than would be allowed if what were in

[129] The Joint Committee's review of the 1955 ruling was at the request of Senator Paul Douglas of Illinois.

[130] *Biddle, supra* note 72.

[131] *See* Report to the Senate Committee on Foreign Relations, Subcommittee on Multinational Corporations, Multinational Oil Corporations and U.S. Foreign Policy, 93d Cong., 2d Sess. (Comm. Print 1975) [hereinafter "Multinational Oil Corporations"].

[132] *Id.*

[133] *See* Rev. Rul. 68-552, 1968-2 C.B. 306, and Rev. Rul 69-388, 1969-2 C.B. 154.

[134] H.R. Rep. No. 13270, 91st Cong., 1st Sess. 432 (1969).

[135] *Id.*

substance royalties were designated as such.[136] The House Report for the Tax Reform Act of 1969 noted that distinguishing deductible royalty payments from creditable tax payments was especially difficult where the foreign taxing authority was also the owner of the mineral right from which the taxpayer derived income.[137] The Senate deleted the House provision on the grounds that the issues required further study, with the understanding that Treasury would study the issue and make recommendations.[138]

A separate limitation proposal similar to the 1969 proposal was included in legislation introduced in 1974, in the midst of the worldwide energy crisis brought on by the actions of the Organization of Petroleum Exporting Countries (OPEC).[139] Without agreeing or disagreeing with the IRS treatment of payments by oil companies on mineral activities to foreign governments as creditable foreign taxes, the Ways and Means Committee concluded that, at a minimum, such taxes should not be allowed to offset the U.S. tax on non-mineral income.[140] Accordingly, the proposal imposed a separate foreign tax credit limitation on FOGEI.[141] FOGEI was defined as taxable income derived from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells and from the sale or exchange of extraction assets, as well as from the purchase and sale of crude petroleum products. This 1974 proposal formed the basis for the foreign oil and gas foreign tax credit limitation provision enacted as part of the Tax Reduction Act of 1975.

The Tax Reduction Act of 1975 was enacted in an anti-oil industry atmosphere. Support for the legislation drew upon the increasingly negative perception of the major oil companies that arose from the continuing oil shortage, a shortage largely caused by a sharp increase in crude oil prices that benefited both the oil companies and OPEC.[142] Beginning with the fourth quarter of 1973, oil company profits were substantially higher than

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[136] *Id.*

[137] *Id.*

[138] The Tax Reform Act of 1969 did include a provision that prevents excess foreign tax credits attributable to the percentage depletion allowance from being used against other foreign income. This provision survives today as § 901(e). Percentage depletion had been regularly criticized as a tax allowance that added to the high profits of the oil companies. Many multinational oil companies operated their foreign activities in branch format during the 1950s and 1960s due to the tax benefit provided by the depletion allowance, a benefit that outweighed the benefit of deferral. *Operation of the Foreign Tax Credit in the Petroleum Industry: a 'Dry Hole'?*, 15 VA. J. INT'L L. 421 (1975). [hereinafter "Dry Hole"]. To avoid giving the oil companies the double benefit of percentage depletion and a high effective foreign tax rate with which to offset U.S. tax on foreign-source income, Congress enacted this reduction in foreign taxes on mineral income allowed as credits. Dry Hole 452.

[139] H.R. REP. No. 1502, 93d Cong., 2d Sess. 61-63 (1974).

[140] *Id.*

[141] *Id.*

[142] Multinational Oil Corporations, *supra* note 131, 1.

in earlier periods.[143] In 1975, Senator Hartke, speaking before the Senate, cited reports showing that the oil companies had paid a low percentage of their worldwide taxes in U.S. taxes and stated that he believed that U.S. oil policy had "helped to finance the international oil cartel which now threatens to destroy our economic system."[144]

In response, Congress enacted the first version of current section 907(a) as part of the Tax Reduction Act of 1975. The provision allowed as creditable taxes only those foreign taxes on FOGEI that did not exceed the amount of such income multiplied by the sum of the U.S. corporate tax rate plus 2 percent.[145] Foreign taxes in excess of that amount were neither creditable nor deductible. In addition, section 907 included a separate foreign tax credit limitation for foreign oil-related income that prevented the use of credits related to such income from offsetting the U.S. tax on non-mineral income and prevented credits on non-mineral income from offsetting the U.S tax on mineral income.[146] Foreign oil-related income was defined, under the 1975 legislation, as taxable income derived from the extraction (by the taxpayer or by any other person) of minerals from oil or gas wells, the processing, distribution, or transportation of such minerals, and the sale or exchange of assets used in any of the aforementioned activities. As defined today, however, foreign oil-related income excludes extraction income. As part of the same tax legislation, current section 907(f) was also enacted, which denies a credit for foreign taxes paid on oil and gas trading if the taxpayer has no economic interest in the minerals and the price is not at fair market value, but allows for such taxes to be deducted.[147]

Beginning in 1976, with Revenue Ruling 76-215,[148] the IRS issued a series of rulings and administrative pronouncements that denied creditability against U.S. tax for payments made to various foreign governments on the grounds that such payments did not constitute income taxes.[149] Earlier

[143] Dry Hole, *supra* note 138, 422.

[144] 121 Cong. Rec. 7484-6 (1975) (amendment proposed by Sen. Hartke).

[145] Tax Reduction Act of 1975, P.L. 94-12, § 601.

[146] *Id.*

[147] *Id.* As part of the Tax Reform Act of 1976, the percentage used in computing creditable extraction taxes was lowered to the highest U.S. corporate rate, *i.e,*, the 2 percent margin above such rate was eliminated. Tax Reform Act of 1976, P.L. 94-455, § 1035. Supporters of this provision again focused on the low U.S. taxes paid by oil and gas companies as compared to their worldwide taxes, and the belief that the existing law resulted in benefits to the OPEC governments, *i.e.,* a shift of revenue from the U.S. Treasury to the OPEC nations. An amendment that would have denied a foreign tax credit for any taxes considered by the IRS to be disguised royalties was rejected in the conference on the 1976 bill. H.R. Rep. No. 1515, 94th Cong., 2d Sess. 460-62 (1976).

[148] 1976-1 C.B. 194.

[149] Staff of Joint Committee on Taxation, Explanation of Foreign Tax Credit Rules Applicable to Petroleum Income and Description of Administration Proposal, JSC-26-79, 11-12 (June 18, 1979).

rulings regarding the creditability of foreign taxes paid on oil and gas income, such as Revenue Ruling 55-296, were revoked. In Revenue Ruling 76-215, the IRS addressed the allowance of a foreign tax credit for payments made to the Indonesian government in connection with a production sharing agreement.[150] Production sharing agreements, which were becoming increasingly popular, involve ownership by the foreign government of the oil and gas reserves, with the private oil company acting as a contractor, furnishing capital, services and technical knowledge. The contractor is compensated in the form of a share of production. Foreign taxes paid by the contractor or on behalf of the contractor to the foreign government are also in the form of a share of production. The IRS held that such payments did not constitute creditable foreign taxes. The ruling was based on the view that since the foreign government already owns all of the oil and gas reserves, no payment is actually made by the contractor to the government and even if such a payment could be identified, it is more akin to a royalty than to an income tax.

In 1977, Treasury and the IRS began developing administrative standards for determining whether a foreign tax was a creditable net income tax. In a series of revenue rulings published in 1978, the IRS set out requirements for a foreign tax to qualify as a creditable income tax.[151] In Rev. Rul. 78-62, the IRS listed three requirements for a creditable income tax: (i) the gain on which the foreign tax is levied must be realized under U.S. principles; (ii) the purpose of the foreign tax must be to reach net gain and it must be structured to achieve this; and (iii) the foreign tax must be imposed on the receipt of income rather than on transactions.

In June 1979, the Treasury issued proposed regulations that provided guidelines for what would constitute creditable foreign taxes for foreign tax credit purposes.[152] The requirements contained in the proposed regulations were based on the requirements outlined in Rev. Rul. 78-62. In November 1980, Treasury issued a more restrictive version of the regulations in temporary and proposed form.[153] These regulations addressed the tax U.S. royalty issue, that is, the same issue addressed by section 907.

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[150] 1976-1 C.B. 194.

[151] *See* Rev. Rul. 78-62, 1978-1 C.B. 226; Rev. Rul. 78-61, 1978-1 C.B. 221; Rev. Rul. 78-63, 1978-1 C.B. 228.

[152] Prop. Treas. Reg. §§1.901-2 and 1.903-1, 44 Fed. Reg. 36,071 (1979).

[153] Prop. and Temp. Treas. Reg. §§ 4.901-2 and 4.903-1, 45 Fed. Reg. 75,647 and 75,695 (1980). C. McClure & H. Bouma, *The Taxation of Foreign Income From 1909 to 1989: How a Tilted Playing Field Developed,* 43 TAX NOTES 1379 (1989). For example, the 1980 regulations provided that their realization, gross receipts, and net income requirements have to be met "without substantial deviation," in contrast to the 1979 proposed regulations.

Legislation in 1982 repealed the prior separate limitation for foreign oil-related income (broadly defined) and modified the section 907(a) restriction on creditable extraction taxes to its current form. Section 907(a) currently limits the amount of foreign taxes on FOGEI that can be credited in a given year by a corporation to the year's FOGEI multiplied by the highest rate of corporate tax specified in section 11(b). Taxes on FOGEI that cannot be credited currently by reason of section 907(a) may be carried forward under section 904(c) and utilized in a later year if the FOGEI limitation in the later year permits. FOGEI is defined as the taxable income or loss from the extraction of minerals and oil and gas wells outside the United States, and from the sale or exchange of assets used in the extraction business of the taxpayer.

Congress also enacted current section 907(b) in 1982, authorizing the IRS to disallow foreign tax credits with respect to foreign oil-related income to the extent that a foreign country imposed abnormally higher taxes on oil-related income than on other income.[154] Foreign oil-related income was defined for this purpose more narrowly than for purposes of the separate limitation enacted in 1975, *i.e.,* extraction income was excluded.[155] The IRS has never directly exercised its regulatory authority under section 907(b). The primary relevance of foreign oil-related income today is to serve as the starting point for determining foreign base company oil-related income under subpart F.

Final regulations regarding what constitute creditable foreign taxes were issued in October 1983.[156] These regulations, which govern today, adopted a more flexible approach than the 1980 regulations to the issue of distinguishing a royalty payment from a creditable income tax. While the 1980 regulations had espoused an "all-or-nothing" approach to the issue, the 1983 regulations allow oil and gas and other taxpayers receiving a "specific economic benefit" from the levying country to split the foreign tax into a creditable income tax amount and a noncreditable amount under a safe harbor election. Alternatively, the creditable portion of the taxpayer's payments to a foreign government can be determined based on all the facts and circumstances.

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[154] Tax Equity and Fiscal Responsibility Act of 1982, § 211(c)(1), amending I.R.C. § 907(b). The extraction loss rule, embodied in current § 907(c)(4), was also amended under this bill, to provide for a net extraction loss from one country to offset extraction income from other countries in calculating the amount of creditable oil and gas extraction taxes.

[155] Section 907(b) was similar to a provision rejected in the conference on the Tax Reform Act of 1976. CONF. REP. No. 1515, 94th Cong., 2d Sess., 1035 (1976).

[156] Treas. Reg. §§1.901-2, 1.901-2A, and 1.903-1, 48 Fed. Reg. 46,272 (1983).

The safe harbor election eliminated the need for section 907(b) because this election provides precise rules for distinguishing creditable foreign taxes from royalties for oil and gas extraction taxpayers. The ALI Study, for example, states that "[s]ection 907(b), relating specifically to taxes on foreign oil-related income, predates the existing Section 901 Regulations; but it is now repetitious and superfluous (assuming that the validity of the section 901 Regulation rule is confirmed)."[157] This explains the IRS's inaction in issuing section 907(b) guidance. It should be noted that, since the drafting of the ALI Study in the mid-1980s, the validity of the section 901 regulations has come to be generally accepted.

The safe harbor election also arguably eliminated the need for section 907(a). Foreign taxes on FOGEI must survive scrutiny under both section 907(a) and the 1983 regulations to be credited, even though these provisions have the same essential purpose, namely, distinguishing tax from royalty. A difference between the two provisions is that, if the general income tax rate in a foreign country on all activities, oil and gas activities included, is high, and all other requirements are met, the 1983 regulations treat the full amount of the levy as a tax rather than a royalty, even though the foreign tax rate exceeds the highest U.S. tax rate.[158] Section 907(a), by contrast, disallows as credits any foreign taxes paid by an extraction company that are in excess of the highest U.S. rate. It seems inappropriate to disallow credits claimed by extraction companies in excess of the U.S. rate in such situations because companies in other industries paying the same high foreign tax rate face no such disallowance.

The Taxpayer Refund and Relief Act of 1999 passed by Congress, but vetoed by President Clinton, would have repealed section 907.

VI. Conclusion

This chapter has explored several general observations regarding the history of the foreign tax credit. One general observation that may be made is that the foreign tax credit rules have become forbiddingly complex and less certain in their application in the past 20 years. It appears the drafters of these rules have not always focused on the compliance and administrative costs of new regimes and refinements and have been unable to fully anticipate these system costs at the time of enactment. Whether or not conceived with this

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[157] ALI Study, *supra* note 1, 304.

[158] This reflects the sound judgment that, to the extent all taxpayers, including those in industries not receiving a specific economic benefit from the levying country, pay a high tax, no portion of that tax is a royalty.

in mind, the current separate foreign tax credit limitation regime strikes a balance between the pursuit of targeted capital export neutrality, revenue and other tax legislative goals, on the one hand, and administrability and certainty of result, on the other. We believe this balance needs to be more explicitly considered notwithstanding that complexity sometimes favors taxpayers in terms of the final tax they owe. For example, in the recent foreign tax credit anti-abuse notice, Notice 98-5, IRS/Treasury introduced a new set of rules to the credit area without ample attention to the system costs of addressing real, but limited, abuses using broadly applicable new regimes.

Second, major features of the current credit regime are the product, at least in part, of Congressional efforts to achieve precise revenue targets for particular credit provisions, to raise revenue generally, or to avoid increasing the federal budget deficit. The 1986 Act's international provisions are a case in point. Sound tax policy is a casualty of revenue-driven tax enactments. The absence of worldwide fungibility under the section 864(e) interest allocation and apportionment rules is one example of a provision structured to achieve a precise revenue target. The absence of a domestic loss recapture provision in the law, paralleling the foreign loss recapture provision in section 904(f), is due chiefly to domestic loss recapture's revenue cost.

Third, the different permutations and combinations of the overall and per-country limitations in effect since 1921 and the more recent proliferation of separate limitations suggest the absence of any theoretically "correct" foreign tax credit limitation formulation. While the overall limitation has been dominant, Congress has been inconsistent over the years in its formulation of the limitation. No consensus has ever been reached among tax experts on a theoretically correct limitation formulation.

A final general observation is that the drafters of the international tax rules, including the foreign tax credit rules, have tended to introduce new rules somewhat more enthusiastically than they have eliminated earlier rules. This has led to some redundancy in the foreign tax credit area, the section 907 oil and gas rules being an example.

There has been an increased willingness on the part of U.S. tax policymakers in the past few years again to emphasize competitiveness concerns in formulating the international tax rules. To assist these efforts in the foreign tax credit area, the remainder of this report will first compare the U.S. foreign tax credit rules with the double tax avoidance rules that have been adopted by other countries that may be expected to share similar concerns. Finally, we will turn to the basic economic policy issues that must be resolved: do the current foreign tax credit rules strike the appropriate balance of economic policies for the global economy of the 21st century?

Chapter 5

Various Approaches to Eliminating Double Taxation

I. Introduction

The assertion of concurrent taxing jurisdiction by two countries would, without some adjustment to mitigate double taxation, greatly inhibit investment abroad. Domestic and foreign income taxes could easily consume most of a corporation's profits.[1] For this reason, virtually all countries seek to avoid double taxation. Some countries prevent double taxation by exempting foreign-source income, other countries by providing a credit against domestic taxes for foreign income taxes imposed by other countries. Still others use a combination of exemption and credit. Although the fundamental aim of each of these systems is to alleviate double taxation, secondary considerations, such as competitiveness abroad, the flow of capital, and fostering international trade, are clearly important.

This chapter compares selected countries' systems of eliminating double taxation with that of the United States. The scope of the comparison is limited to the double taxation of repatriated profits. The deferral regimes of the selected countries, the subject of a separate NFTC report, and the implications of transfer pricing for the various systems are not considered.[2] In other words, the discussion focuses not on when taxation occurs or how income is allocated among taxing jurisdictions, but on how double taxation is ultimately relieved.

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[1] A deduction for the foreign taxes would alleviate some, but not much, of this double tax burden.

[2] *See* THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY; PART ONE: A RECONSIDERATION OF SUBPART F (March 25, 1999) [hereinafter "NFTC Subpart F Report"].

Only the significant features of the selected countries' systems are highlighted. The chapter is not exhaustive and is not intended to imply that the examined features are alone determinative of an overall tax advantage or disadvantage for U.S.-based multinationals. Nonetheless, it does demonstrate that in many important areas the U.S. double tax relief system is unduly harsh and that it often fails to eliminate double taxation of U.S.-based multinationals. Perhaps more importantly, however, the chapter shows that, to date, none of the other countries have adopted similarly restrictive provisions. Thus, at least with respect to double taxation, U.S-based multinationals are at a disadvantage when they compete with foreign-based multinationals headquartered in the selected countries.

This finding is important because the countries selected for discussion—Canada, France, Germany, Japan, the Netherlands, and the United Kingdom—constitute, together with the United States, the countries with the most corporations that are among the world's largest 500 corporations. In the aggregate, these countries are home to 412 of the 500 largest multinational corporations in the world and it is large multinationals from these countries that compete with U.S.-based multinationals abroad.[3]

II. Overview of Credit and Exemption Systems

A. Exemption System

A pure exemption system completely exempts foreign-derived income from residence country taxation.[4] Under this territorial approach, the home country simply relinquishes its jurisdiction to tax income earned abroad, so that only foreign tax is imposed on foreign income. In this way, the exemption system fosters a policy of capital import or competitive neutrality because competing entities in a given market are saddled with comparable tax burdens.

One shortcoming of the exemption system is that an incentive exists to invest outside the home country whenever the domestic tax rate exceeds tax rates abroad. Another drawback of exemption is that it places tremendous

[3] Based on the Financial Times 500, THE FINANCIAL TIMES, January 22, 1998. The 412 figure includes a corporation with its home in both the United Kingdom and Australia, and a corporation with its home in both the Netherlands and Belgium.

[4] Some countries utilize a variation of the exemption system, labeled "exemption with progression." Under this system, foreign exempt income is included in domestic taxable income solely for determining the progressive tax rate applicable to domestic income.

pressure on transfer pricing and sourcing provisions, since foreign income completely escapes domestic taxation. On the other hand, exemption regimes are generally more easily administered than credit regimes in that a determination of creditable foreign taxes and a credit limitation computation are not necessary.

B. Credit System

Under a credit system, a taxpayer's income is subject to domestic taxation regardless of its origin. Double taxation is then mitigated by crediting the taxpayer's domestic tax liability for the foreign income taxes it incurs. The credit is usually limited, however, so as not to allow it to exceed the pre-credit domestic tax applicable to the taxpayer's foreign income. Thus, foreign taxes are generally not creditable to the extent they exceed this amount. On the other hand, when foreign tax rates are less than the domestic tax rate, an additional domestic tax, generally referred to as a residual or incremental tax, is collected for the difference.

In contrast to the exemption system, the credit system strives to achieve capital export neutrality by ensuring that both foreign-source and domestic-source income are taxed at no less than the domestic tax rate.[5] While such a policy eliminates any tax incentive to invest abroad, it necessitates complex credit computations and the tracking of foreign income and associated foreign taxes. Consequently, the credit system involves more intricacy than the exemption system, which need not take foreign income and foreign taxes into account.

C. Combination Systems

Many countries employ hybrid systems.[6] For example, Canada grants an exemption for dividends received from foreign subsidiaries located in treaty partner countries and a credit for dividends received from subsidiaries located in non-treaty countries. Similarly, Germany exempts branch income earned in treaty countries and foreign-source dividend income, but provides a credit for branch income earned in non-treaty countries.

[5] Of course, when foreign rates exceed domestic rates, capital export neutrality is not truly achieved because a credit for foreign taxes in excess of the domestic tax is not permitted. Nonetheless, double taxation is eliminated.

[6] Most countries, including the United States, utilize both credit and exemption principles in their systems, but cannot properly be characterized as employing hybrid systems. The United States, for instance, exempts certain foreign-earned income of U.S. citizens under I.R.C. § 911, even though it otherwise relies on a credit to eliminate double taxation. Hybrid systems are distinguishable in this regard because they rely heavily on both exemption and credit methods.

D. Mechanical Illustration of Credit and Exemption Systems

Although the exemption and credit approaches differ mechanically, Example 1 illustrates that both produce equivalent relief when foreign tax rates exceed the domestic tax rate.

Example 1 Higher Foreign Tax Rate

	Double Tax	Exemption System	Credit System
Foreign-Source Income	100	100	100
Country of Source Tax (40%)	40	40	40
Tentative Domestic Tax (35%)	35	0	35
Less Tax Credit	–	–	(35)
Final Domestic Tax	35	–	–
Total Tax	75	40	40

Results differ when foreign tax rates are less than the domestic tax rate. In this situation, the credit system imposes a residual tax whereas the exemption system does not. This is illustrated in Example 2.

Example 2 Higher Foreign Tax Rate

	Double Tax	Exemption System	Credit System
Foreign-Source Income	100	100	100
Country of Source Tax (30%)	30	30	30
Tentative Domestic Tax (35%)	35	0	35
Less Tax Credit	–	–	(30)
Final Domestic Tax	35	–	5
Total Tax	65	30	35

III. Overview of Systems Employed by Selected Countries

To facilitate the comparison, this section summarizes key aspects of each country's system, describing its basis for taxing repatriated profits, the various types of double tax relief it offers, the limitations it imposes on its relief, and other provisions that indirectly affect its allowable relief (*i.e.,* expense allocation rules, loss re-sourcing rules, etc.).

In general, the United States, the United Kingdom, and Japan utilize a credit system, the systems of France and the Netherlands are predominantly exemption-based, and the systems of Germany and Canada fall somewhere in between a credit and an exemption system. Table 1, included at the end of this chapter, summarizes the key aspects of the systems discussed below.

A. United Kingdom

The United Kingdom taxes resident companies on their worldwide income. Relief from double taxation is then provided through a credit system. The United Kingdom grants this relief unilaterally through domestic legislation and bilaterally via double taxation agreements, although in most cases, U.K. treaties provide very little in the way of additional benefits.

1. Types of Relief Available

The United Kingdom allows a credit for foreign income taxes paid directly by U.K. resident companies and for foreign income taxes paid indirectly by U.K. resident corporations through their related foreign subsidiaries. The indirect tax credit works in a manner similar to the U.S. indirect foreign tax credit (*i.e.*, when profits are repatriated, the underlying foreign tax associated with those profits is allowed as a credit, subject to a credit limitation).[7] The indirect tax credit is available to U.K. companies controlling, directly or indirectly, 10 percent or more of the voting power of a first-tier subsidiary. In addition, the credit is permitted for multiple tiers of foreign subsidiaries beneath the first-tier subsidiary provided that, at each point down the chain, each successive upper-tier subsidiary maintains ownership of 10 percent or more of the votes of each successive lower-tier subsidiary.[8] This rule enables a U.K. corporation to credit foreign taxes paid by a corporation in which it holds a very minor economic interest.

[7] The net dividend received is grossed up for deemed taxes paid as well as withholding taxes.

[8] The U.S. indirect credit under I.R.C. § 902 applies only through six tiers.

2. Limitations on Relief

In computing the allowable credit, the United Kingdom has adopted a strict source-by-source, item-by-item credit limitation. Under this limitation, the credit on a particular item of income is limited to the extent the foreign tax on that item exceeds the U.K. tax on that item. While such an approach prevents the averaging of taxes between high-tax and low-tax jurisdictions (although see below), it imposes the onerous task of computing a credit separately for each item of income.[9]

In the event that the foreign tax on an item of income is more than the U.K. tax on such income, the excess foreign tax is (with one exception, discussed below) never creditable because there is no carryover mechanism under U.K. law. Consequently, in situations where no U.K. tax liability exists for the credit to offset, it is necessary to disclaim the credit and take a deduction since, unlike credits, losses can be carried forward. Credits can be disclaimed in favor of deductions each year on a per-country basis.

The United Kingdom's strict item-by-item limitation and its restrictive carryover mechanism may seem harsh but, to a large extent, proper structuring in fact gives U.K. corporations the ability to average high-taxed and low-taxed income; the extent of such averaging has been narrowed by new legislation with effect from March 31, 2001.

a. Dividends Received before March 31, 2001

Before March 31, 2001, look-through rules did not exist to require a dividend passed through a chain of corporations to retain its underlying source. For this reason, many U.K. companies found it advantageous to hold their foreign subsidiaries through a "mixer" entity located in a low-tax jurisdiction such as the Netherlands. In this way, low-taxed and high-taxed dividends from different subsidiaries were blended before their source was ultimately determined at the mixer company level. Thus, rate averaging with respect to foreign dividends was easily accomplished under the U.K. indirect credit rules prior to March 31, 2001.

b. Dividends Received on or after March 31, 2001

New rules permit onshore pooling for foreign dividends received on or after March 31, 2001.[10] Under the new regime, certain low-taxed dividends can be pooled onshore and eligible unrelieved foreign tax (EUFT) on high-taxed dividends can be credited against the U.K. tax arising on

[9] Generally, a limitation computation is necessary for each separate schedule on the U.K. tax return.

[10] The legislation, as originally enacted, severely restricted the ability to mix high and low-taxed dividends.

the pooled low-taxed dividends. Excess EUFT can be carried back three years or forward indefinitely.

There is a cap of 45 percent on the rate of foreign tax that can be offset in this way and there are some restrictions on the types of dividends that can be mixed. For example, low-taxed dividends from companies subject to the United Kingdom's controlled foreign companies (CFC) legislation cannot be mixed.[11]

3. Other Provisions Affecting Relief

Many of the complexities and burdens inherent in the U.S. system are absent from the U.K. system. For instance, there are no detailed requirements for allocating expenses, such as interest, between U.K. and foreign-source income, nor are there rules similar to the U.S. overall foreign loss (OFL) provisions. Thus, domestic income generated subsequent to a foreign loss is not re-sourced.[12]

Another favorable aspect of U.K. law is that U.K. tax treaties often include tax sparing provisions to deal with special tax incentives granted by developing countries to encourage investment. Under these provisions, the tax a foreign country would have levied had it not been for the incentive is treated as if it is actually paid. This ensures that the incentives are not nullified by the imposition of a residual U.K. tax.[13]

B. Japan

Like the United Kingdom, Japan taxes Japanese corporations on their worldwide income and then provides double tax relief through a credit system.[14]

1. Types of Relief Available

Both foreign income taxes paid directly by Japanese corporations and foreign income taxes paid indirectly through their foreign subsidiaries are creditable.[15] The indirect credit is available to Japanese corporations on

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[11] A foreign subsidiary is subject to the CFC provisions only if its income is subject to a low rate of tax. Very generally, its income must be subject to a foreign tax that is not higher than 25 percent of the tax the United Kingdom would have imposed.

[12] The same holds true for foreign income generated subsequent to a domestic loss.

[13] The U.S. government has not adopted tax sparing provisions in its treaties. It takes the position that tax sparing provisions violate the capital export neutrality standard because they encourage foreign investment over U.S. investment for tax reasons.

[14] In certain circumstances, an exemption approach is used for international transportation income.

[15] Foreign taxes are creditable against both the national and local inhabitants corporate income taxes, but are not creditable against the corporate enterprise income tax.

dividends from first-tier and second-tier foreign subsidiaries in which they hold a voting interest of 25 percent or more.[16] The indirect credit computation is similar to the U.S. and U.K. computations.

2. Limitations on Relief

Of the countries considered, Japan has by far the simplest and most generous approach to limiting its foreign tax credit. With a few modifications, it uses an overall foreign income-to-worldwide income ratio to determine its credit limitation. This overall approach not only permits full rate averaging, it also requires only one limitation computation as opposed to the multiple computations that are often necessary when the limitation must be calculated on a separate item or basket basis.

A few additional limitations apply to the limitation calculation. First, two-thirds of any item of income not taxed outside Japan is excluded from the numerator of the limitation formula.[17] Second, the ratio of foreign to worldwide income in the limitation formula may not exceed 90 percent. Finally, with respect to the indirect tax credit, foreign taxes are not creditable to the extent they exceed 50 percent of the tax base in a given country. The excess tax may, however, be deducted.

Unused credits, excluding those due to the 50 percent restriction, may be carried forward for a period of three years. In addition, unused excess limitation that arises in a given year may be carried forward for three years.[18] Alternatively, a taxpayer unable to utilize credits can elect to deduct its foreign taxes in a given year. Such an election must be made with respect to all foreign taxes for the particular year, and, if the election is made, existing carryforwards of unused taxes or unused limitation are eliminated.

3. Other Provisions Affecting Relief

Like the United Kingdom, Japan permits foreign-source losses to offset income from domestic sources without subsequent recapture. Thus,

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[16] Additional requirements also must be met. The Japanese parent must own stock in the first- and second-tier subsidiaries for at least six months prior to the dividend declaration date. With respect to second-tier corporations, the credit is only available to the extent a dividend is paid by the first-tier entity out of earnings that include the dividend from the second-tier entity. Additionally, only indirect ownership is considered for purposes of the requirement of 25 percent ownership of the second-tier subsidiary.

[17] Exceptions are made where there is a tax sparing provision in a relevant treaty.

[18] Disregarding the mechanics of the computation, the allowance of a three-year carryforward of excess limitation is essentially the same as allowing a three-year carryback of excess credits.

Japanese corporations need not be concerned with re-sourcing rules similar to the U.S. OFL provisions.

Nor does Japan have detailed expense allocation rules like those in the United States. Guidelines regarding the allocation of expenses to foreign-source income simply require an allocation on a reasonable basis such as revenue, assets, or employees. With regard to interest expense, a direct tracing approach is typically used.

Japan also has an extensive tax treaty network. Although Japan's treaties usually only restate the unilateral relief available, concessions are made in some instances. For instance, the 1971 Japan-U.S. tax treaty permits Japanese corporate taxpayers to receive an indirect credit for U.S. income taxes paid by a 10 percent-owned U.S. subsidiary rather than requiring the normal 25 percent relationship. Further, several of Japan's treaties contain tax sparing provisions designed to preserve the benefits of tax holidays offered by developing countries.

C. France

France utilizes a territorial system of taxation, under which foreign profits, whether derived through a foreign branch or a foreign subsidiary, are exempt from French corporate income tax.

1. Types of Relief Available

As a general rule, foreign income earned directly by a French company is exempt from French taxation. The income must be attributable to a foreign permanent establishment or other independent establishment that regularly conducts business activities.[19]

Foreign subsidiary income of a French multinational is also generally exempt from French tax.[20] Such income is not taxed when it is earned by the foreign subsidiaries and 95 percent of it is exempt on repatriation to France. This exemption applies provided the French recipient owns 5 percent of the

[19] The other establishment must derive income from a complete commercial cycle carried on abroad as a habitual business activity. A complete commercial cycle means the resale of purchased or manufactured goods.

[20] Although foreign-source income is usually not subject to the corporate income tax, a separate equalization tax (*précompte mobilier*) is imposed on a French corporation when the corporation distributes exempt foreign-source income to its shareholders. Although this tax is imposed on the corporation and reduces its dividend paying capacity, the French individual receiving the dividend receives a credit for the tax paid by the corporation. Hence, except for the fact that the corporation remits the tax, the tax is essentially a prepayment of the French shareholder's individual level tax, instead of an additional corporate tax. This tax on distributed earnings is ordinarily not a significant barrier to business operations and cash utilization because capital can be repatriated to a French parent corporation and redistributed to other foreign operations without triggering imposition of the tax.

equity capital of the paying company and provided the recipient either subscribed for the original shares or purchased the shares with the intention of holding them for at least two years.

There are some exceptions to France's application of the territorial system. Subject to the approval of French tax authorities, a French corporation may elect to be taxed on its worldwide income (*régime du bénéfice mondial*) (*i.e.,* corporate taxable income would include the income of its foreign branches, but not its subsidiaries) or on a worldwide consolidated basis with its foreign subsidiaries that are at least 50 percent owned (*régime du bénéfice consolidé*). Because of its restrictive nature, the *régime du bénéfice mondial* has never been used. In addition, ministerial approval to use worldwide consolidation has only been granted to approximately 10 of France's most important companies. Companies using worldwide consolidation may claim foreign tax credits subject to a per-country limitation. Excess credits for a given year may either be carried forward for five years or deducted in computing income.

2. Limitations on Relief

An exemption is not allowed for specifically defined types of low-taxed, non-business income. A French company is required to pay French tax on its *pro rata* share of any foreign-source income deemed received under the French CFC rules.[21] A foreign tax credit is then usually allowed for the foreign taxes borne by the foreign entity.

3. Other Provisions Affecting Relief

France does not have detailed statutory rules dealing with the allocation of expenses to exempt foreign-source income. Expenses that are directly related to exempt foreign-source income are non-deductible. Expenses that are not directly related must be apportioned between taxable and exempt income and are likewise non-deductible.

A rather generous rule applies to interest expense incurred by a French corporation relative to its purchase of a foreign subsidiary. This interest expense is fully deductible against the corporation's French taxable income, even though 95 percent of the foreign subsidiary's income is exempt from French taxation.

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[21] The CFC rules only apply to holdings of 25 percent or more in entities that are not principally engaged in the conduct of commercial or industrial activities in the local market. Further, the controlled entity must be operating in a low-tax jurisdiction. A low-tax jurisdiction exists if the income tax imposed by the foreign jurisdiction is less than two-thirds of the tax that would have been paid had the income been earned in France.

Finally, since France fully excludes foreign income from French taxable income, foreign losses never enter into French taxable income. Thus, re-sourcing provisions like the U.S. OFL rules are not necessary.

D. The Netherlands

Like France, the Netherlands employs an exemption system, except in a few instances in which a credit system is utilized.

1. Types of Relief Available and Associated Limitations

a. Relief for Foreign Branches

A Dutch corporate resident carrying on a foreign business directly through a permanent establishment receives a "proportional tax reduction" that reduces Dutch tax (computed on a tax base of domestic income plus income from foreign permanent establishments) by the taxpayer's net foreign permanent establishment income expressed as a percentage of its total taxable income.[22] The reduction effectively amounts to a full exemption because Dutch corporate tax rates are not progressive.

Special rules exist for permanent establishments operating at a loss. A net loss from a permanent establishment in a particular country may be offset against Dutch taxable income from domestic sources in the year it is incurred. Subsequent profits from that permanent establishment or another permanent establishment in the same jurisdiction, although included in Dutch taxable income, only create an exemption from Dutch tax to the extent they exceed the previous losses offset against domestic income. This taxpayer-favorable provision allows a Dutch multinational the full benefit of a foreign loss in the period it is incurred, but ultimately ensures that the proportional reduction is granted only for the cumulative net profit arising from one or more permanent establishments in a given country.

Similar adjustments are required when a domestic loss offsets foreign profits. In this case, domestic losses reduce foreign profits and the corresponding proportional reduction. Thereafter, an indefinite carryforward equal to the amount of the domestic loss is established. When subsequent domestic income arises, the proportional reduction calculation is adjusted

[22] The Netherlands' branch exemption system under its tax treaties generally applies even if the foreign income is not subject to foreign tax. Permanent establishments in non-treaty countries must be subject to foreign income tax to qualify for the exemption. In addition, the branch exemption will not apply to branches the activities of which consist largely (*i.e.*, more than 50%) of investment activities or passive group finance activities. In these cases, relief from double taxation is granted via the credit method. The credit in these cases is limited to the Dutch tax due on the foreign income. If there is an applicable tax treaty, the credit method will only apply if the treaty does not prescribe the exemption method.

so that, over the long run, the taxpayer obtains a reduction for the foreign-source income previously offset by domestic losses. Thus, unlike the U.S. OFL rules, the Dutch loss rules treat both domestic and foreign losses uniformly.

b. Relief for Foreign Subsidiaries

A Dutch corporate resident operating abroad through a foreign subsidiary generally receives relief through the "participation exemption." Under the participation exemption, dividends received from a foreign subsidiary and capital gains realized on the sale of a foreign subsidiary are generally exempt from Dutch taxation provided the subsidiary's profits are subject to tax in the foreign jurisdiction.[23] Unlike the proportional reduction, participation distributions never figure into the calculation of Dutch taxable income.[24]

c. Limited Application of Credit System

Application of the credit system in the Netherlands is limited to withholding taxes on certain types of income earned in less-developed countries. Generally, a credit for withholding taxes on passive income such as dividends, interest and royalties is allowed if the income is paid by a corporation or debtor located in a "developing country" and the income is not otherwise excluded from the Dutch taxpayer's domestic income (*i.e.*, under a treaty or otherwise).[25] In general, the credit is limited by multiplying the pre-credit Dutch tax payable by the ratio of developing country income (all dividends, interest and royalties are combined for this purpose) to worldwide income. Credits disallowed because of this limitation can be carried forward indefinitely.

2. Other Provisions Affecting Relief

As a general rule, interest expense associated with a foreign participation is not deductible. In this regard, interest expense generated on a loan

[23] If the foreign subsidiary's activities consist largely (*i.e.*, more than 50 percent) of investment activities or passive group finance activities, the participation exemption will not be available. Consequently, dividends received and capital gains realized will be subject to Dutch corporate income tax.

[24] Foreign taxes on exempt distributions are generally not creditable, but an exception applies to Dutch intermediate companies. A Dutch intermediary receiving an exempt dividend can credit a portion of any foreign withholding tax imposed on the exempt dividend against any Dutch withholding tax imposed on further distributions of that dividend to its foreign owners. Unlike a typical reduction in withholding tax, however, this reduction benefits the Dutch corporation and not the shareholder. This is because the Dutch corporation is still required to withhold at the applicable rate, but is only required to pay a small portion of the amount withheld over to the Dutch tax authorities. The difference remains with the Dutch company. Several conditions, not discussed here, also must be satisfied for this credit to be available.

[25] The Ministry of Finance has issued a decree specifying which countries are considered "developing countries." In some cases, the Dutch tax treaty network permits a credit for foreign withholding taxes, even if no such taxes are imposed. This tax sparing credit generally applies to less-developed countries that provide tax incentives to encourage investment.

entered into within six months of the acquisition of a foreign participation is presumed to be related to the participation unless the taxpayer can demonstrate that it is not so related. Beyond this, however, the Netherlands does not have detailed rules concerning the allocation of expenses to foreign-source income.

E. Canada

Canada employs a residence-based tax system that subjects Canadian companies to tax on their worldwide income. Relief from double taxation is then provided by way of a combination credit and exemption system.

1. Types of Relief Available and Associated Limitations

a. Relief for Branches

Two types of credits are allowed to Canadian corporations for taxes they pay directly to foreign governments. They are the foreign non-business income tax credit and the foreign business income tax credit. The foreign non-business income tax credit applies to foreign taxes paid on passive income such as interest, dividends from non-affiliated entities, rents, royalties, and capital gains. The foreign business income tax credit applies to foreign taxes paid relative to foreign-source business income.

Canada limits its credits on a per-country basis.[26] In addition to the per-country limitation, there is a further subdivision into non-business income and business income baskets. To the extent the non-business income credit is limited, the excess tax can be deducted but cannot be carried forward. In contrast, if the foreign business income tax credit is limited, the excess tax can be carried back to the three preceding years and then forward to the next seven years on a per-country basis.[27] Also, if the use of foreign tax credits prevents a taxpayer from utilizing other domestic credits, the taxpayer may elect not to claim the full foreign tax credit so that its other credits may be fully utilized. Unused foreign business income tax credits resulting from this election still carry over to subsequent and preceding years.

A foreign loss from a branch in one country reduces Canadian domestic income and has no effect on the limitation calculations for other jurisdictions. Further, subsequent foreign-source income is not recaptured

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[26] The taxpayer's total pre-credit tax is multiplied by the ratio of its foreign income from a given country to its worldwide income.

[27] It should be noted that the ability to carry over foreign business income tax credits is contingent on continuing to carry on the business in the foreign country concerned.

as domestic-source income, even though the prior foreign loss offsets domestic income.

b. Relief for Foreign Subsidiaries

Depending on the countries and the nature of the income involved, Canadian corporations receiving dividends from foreign affiliates obtain double tax relief through either an exemption or an indirect foreign tax credit.

To the extent a foreign subsidiary pays a dividend to a Canadian parent out of its "exempt surplus," the dividend is effectively exempt from Canadian tax and no foreign tax credit is allowed. In general, exempt surplus consists of income earned in the active conduct of a trade or business in any country with which Canada has concluded a tax treaty (provided the foreign subsidiary is a resident of that country).

To the extent a dividend is paid out of "taxable surplus" to a Canadian parent, the dividend is taxable. An indirect credit, subject to the credit limitations discussed above, is then granted for the underlying tax associated with the dividend, provided the parent owns at least 10 percent of the shares of any class of stock in the subsidiary. Taxable surplus consists of passive types of income and business income earned in non-treaty countries.

2. Other Provisions Affecting Relief

A particularly favorable aspect of Canada's credit regime is that it offers taxpayer's relief when overall losses limit a taxpayer's ability to claim foreign tax credits (*i.e.,* because of insufficient domestic liability). In these situations, special provisions allow for a notional foreign tax credit, the effect of which is to transform the permissible foreign tax credit into an equivalent increase in the taxpayer's net operating loss carryforward. This preserves the value of the foreign tax credit in many situations in which it would otherwise be lost.

The Canadian expense sourcing laws are not very elaborate. Expenses are initially traced to, and reduce, specific income. If tracing is impractical, expenses are then allocated on a reasonable basis.[28] There are no rules for specific expenses, such as interest. Therefore, when dividends are paid out of the taxable surplus of a foreign subsidiary, the Canadian parent's interest expense (and other expenses related to holding shares in its foreign affiliates) generally does not reduce the credit relief allowed. Moreover, an even larger subsidy in this respect is that similar carrying charges associated with holdings in affiliates paying exempt dividends are also deductible.

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[28] A formula based on either asset values or gross income is usually used.

F. Germany

German law generally provides that German resident corporations are subject to tax on their worldwide income. Nevertheless, Germany accomplishes most of its double tax relief through exemption.

1. Types of Relief Available and Associated Limitations

a. Exemption Relief

A statutory exemption excludes 95 percent of any foreign dividend from a German resident corporation's German taxable income.[29] This exemption applies regardless of the German corporation's ownership level in the foreign corporation and irrespective of whether a treaty applies.[30] With regard to the 5 percent inclusion, a foreign tax credit is allowed to the extent of any allocable withholding tax.

Foreign branch income, though not statutorily exempt, is exempt under Germany's tax treaties. To qualify, the income must generally be earned in a treaty jurisdiction and, under some treaties, be subject to foreign tax.[31] In contrast to the foreign dividend exemption, there is no 5 percent inclusion amount for the branch exemption.

Special CFC rules apply to specifically defined types of passive investment income. Dividends and branch profits of this nature that are derived in low-tax jurisdictions are not permitted an exemption. Instead, such income is included in German taxable income and double taxation is relieved through a foreign tax credit. Typically this results in the collection of a residual German tax since not much foreign tax will be associated with such income.

b. Credit Relief

In situations where a treaty does not apply, foreign branch income is included in German taxable income and double taxation is relieved through a foreign tax credit. The credit is limited on a per-country basis to the pre-credit German tax on the branch income. A carryover for taxes paid in excess of this limitation is not allowed, but the excess may be deducted.

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[29] The exemption is also available to German partnerships to the extent they have corporate owners.

[30] Before January 1, 2001, these dividends were exempt only when earned by subsidiaries in treaty partner countries and only if a 10 percent minimum holding requirement was satisfied.

[31] Credit treatment would apply to any investment income that is denied an exemption.

2. Other Provisions Affecting Relief

Germany's expense allocation laws are relatively generous. For instance, interest expense related to the acquisition and financing of a foreign holding generating exempt dividends is fully deductible by a German parent corporation.

Germany's provisions on foreign losses are not very favorable. Foreign branch losses are not deductible. As a result, loss recapture rules are not necessary. However, in situations where the credit regime applies, branch losses can be carried forward for offset against future income of the respective branch. Thus, a benefit for the branch loss, albeit delayed, is ultimately obtained.

IV. Comparisons of Specific Aspects of Foreign Systems to U.S. System

A. Foreign Tax Credit Basketing

Eliminating double taxation on one item of income is fairly straightforward. All things being equal (including domestic tax rates), the surveyed countries' credit regimes would yield identical results because each country limits its credit to the pre-credit domestic tax associated with foreign-source income. Mechanically, this is achieved by multiplying the pre-credit domestic tax by the ratio of the taxpayer's foreign-source income to total taxable income.

Differences between the systems arise, however, when there are multiple items of foreign income. These differences exist because the systems surveyed permit varying degrees of rate averaging (*i.e.,* allowing high-taxed and low-taxed income to be combined into a single credit limitation computation, the effect of which is to lower the effective tax rate on high-taxed foreign income so that a larger foreign tax credit is permitted). For instance, Japan, through the use of an overall limitation, permits full rate averaging. The United Kingdom, on the one hand, strictly prohibits rate averaging with respect to branch income but, on the other hand, allows a significant degree of rate averaging on foreign dividends. Other countries, such as Canada and Germany, apply per-country limitations.

The U.S. limitation is generally the most complex, requiring a limitation computation for nine specifically designated categories of income ("baskets"). The intent behind the basketing rules is simple enough to understand, but those complying with the rules would surely wonder whether the intended benefits they achieve justify the compliance burden they impose. For each separate basket, gross income items must be identified, expenses must be allocated, creditable taxes must be determined, “look-through” rules may need to be applied, a credit carryover mechanism must be provided, and losses incurred within the basket must be addressed. This complexity multiplies with the addition of each new basket for which a U.S. multinational must compute a limitation. In addition to being the most complex, the U.S. basketing system is also the most restrictive of the systems surveyed.

1. Example of Rate Averaging Allowed by Surveyed Countries

The following example illustrates that most multinationals in the surveyed countries can cross-credit foreign taxes.

Assume a corporation receives a $100 dividend (made up of business income) from its wholly-owned Country A subsidiary and a $100 dividend (consisting of royalty income) from its wholly-owned Country B subsidiary. Further, assume that $44 of Country A tax and $15 of Country B tax are associated with the respective dividends, and, for ease of comparison, that the selected countries tax corporate income at a flat 35 percent rate. (It should be noted that this hypothetical 35 percent rate would need to be adjusted to determine the exact benefits of rate averaging for companies located in the various countries.)[32]

The Japanese overall limitation is by far the most generous with regard to allowing cross-crediting of taxes.[33] Under the Japanese overall limitation approach, all foreign-source income is combined for purposes of computing the limitation. As a result, the Japanese foreign tax credit would equal $59, *i.e.*, the lesser of the Japanese tax on the combined foreign-source income of $70 ($200 x 35%) or the actual foreign taxes imposed of $59. Under this overall limitation, the excess limitation generated on the Country B dividend is absorbed by the excess foreign tax generated on the Country A dividend.

[32] Rate averaging is less beneficial for taxpayers in high-tax jurisdictions. The higher the home country rate, the less likely it is that a taxpayer’s credit will be limited since foreign income taxes will often not exceed the domestic tax.

[33] It is important to note that the Japanese tax rate is higher than that of the United States, so that rate averaging is not as beneficial to Japanese corporations.

A U.K. corporation could also achieve full rate averaging in this situation because even though the U.K. system imposes an item-by-item, source-by-source limitation, onshore pooling effectively allows averaging on foreign dividends.[34]

For all intents and purposes, multinationals operating under the exemption systems of France, the Netherlands, Canada and Germany effectively receive the benefits of rate averaging in that these systems generally do not limit the amount of relief available on high-taxed foreign income (*i.e.,* the income taxed at 44 percent will be relieved even though that tax exceeds the 35 percent home-country rate).[35]

In comparison, the U.S. system would prevent cross-crediting of the Country A and Country B taxes. Under the U.S. basketing system, a separate credit limitation would be necessary for the respective dividends. The dividend of business income would be included in the general limitation basket and granted a credit of $35.[36] The dividend of royalty income would be included in the passive basket and granted a credit of $15.[37] In the end, the U.S. multinational would be allowed a total credit of $50.

Canada's per-country limitation under its credit regime (which would be applicable if Country A and Country B were non-treaty countries), would produce a limitation similar to that of the U.S. system (as would the German and U.K. credit regimes that pertain to branch income). The Canadian and German credit systems would permit averaging only if the two subsidiaries were located in the same country.

2. Conclusion

Proponents of a basketing system might credibly argue that the U.S. result is proper. Double taxation on each item of income is eliminated and a full credit for foreign taxes paid is not warranted since such a credit would offset tax on domestic income. Others might argue that the overall limitation approach provides a more accurate result because it reflects the integrated nature of multinational operations abroad. Moreover, they would question

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[34] Some limitations apply under U.K. law. Under the new onshore pooling regime, the foreign rate of tax cannot exceed 45 percent and the foreign subsidiary paying the dividend can not be subject to the U.K. CFC provisions.

[35] Taxpayers under these exemption systems would pay a total of $59 in tax on their income in the example.

[36] Computed as follows: (the lesser of the foreign tax of $44 or the U.S. tax applicable to such income of $35 ($100 X 35%)).

[37] Computed as follows: (the lesser of the foreign tax of $15 or the U.S. tax applicable to such income of $35 ($100 X 35%)).

the substantial compliance costs and complexity associated with a basketing system. Persuasive arguments exist on both sides. The point to be made, however, is that U.S. corporations are usually subject to more stringent cross-crediting limitations than their foreign-based competitors operating in the selected countries.

B. Interest Allocation Rules

The elimination of double taxation is further impeded and the complexity of the U.S. rules is further exacerbated by the U.S. interest allocation rules. These rules require U.S. multinationals to allocate domestic interest expense to foreign-source income. This allocation decreases foreign-source income and ultimately the foreign tax credit allowed to a U.S. multinational. These rules significantly tilt the playing field to give foreign multinationals a competitive edge. None of the other countries studied have adopted similarly stringent provisions. To the contrary, many of the countries go to great lengths to allow their multinationals a full interest expense deduction.

The theory behind the U.S. interest allocation rules is that money is fungible and that it is attributable to all activities and properties of a multinational enterprise regardless of where it conducts business. Furthermore, the rules theorize that management has great flexibility regarding the source and use of funds and that borrowed funds free up money for other purposes.[38] Though the U.S. interest allocation rules purport to adopt this concept of fungibility, in actuality they do not. Instead, the rules look only to the domestic interest expense of a U.S. affiliated group. They do not take into account the interest expense of a foreign subsidiary even though true fungibility principles would espouse such an approach. This "water's edge" rationale clearly violates the fungibility concept on which the rules are based and often results in double taxation.

The rules operate by allocating the domestic interest expense of a U.S. affiliated group against its foreign-source income in each foreign tax credit basket based on a fraction, the numerator of which is the tax basis or fair market value of the group's U.S. assets in that basket and the denominator of which is the total basis or fair market value of all U.S. and foreign assets in all baskets.[39] For this purpose, an affiliated group does not include foreign subsidiaries of the U.S. parent; rather, the stock bases of its foreign subsidiaries are treated as assets of the affiliated group. It is important to note

[38] Treas. Reg. § 1.861-9T(a).

[39] A taxpayer can elect to use fair market values in lieu of using tax book values. Also, interest is directly allocated where: (i) non-recourse debt can be tied to income from a specific property; (ii) debt can be traced to financing an integrated financial transaction; or (iii) debt can be directly linked to money that is lent to a CFC by a U.S. shareholder.

that interest allocated under the U.S. rules is not deductible for foreign tax purposes. It has no impact on the actual taxes a foreign subsidiary must pay.

1. Double Taxation Caused by U.S. Interest Allocation Rules

The example below demonstrates how the interest expense allocation rules effectively result in double taxation.

Assume the following facts: USP, a U.S. multinational, wholly owns Forco, a foreign corporation doing business in Country X. Forco incurs $1,000 of interest expense relative to a loan it has with a Country X bank, and USP incurs $1,000 of interest expense from a U.S. bank. The Forco loan was procured solely for the purpose of financing Country X operations and the U.S. loan was procured solely to finance U.S. operations. Assume also that USP and Forco each earn income of $1,000 after interest expense, that Forco pays $300 of Country X tax relative to such income and that Forco distributes its after-tax income of $700 to USP. Assume the worldwide assets are owned 50 percent by USP in the United States (excluding USP's Forco stock from the calculation) and 50 percent by Forco in Country X. Finally, assume USP's Forco stock accounts for 50 percent of its total assets.

As the calculation shows, the water's edge allocation permits USP to credit only $175, while the worldwide allocation permits a full $300 credit. This result occurs because the water's edge allocation fails to consider Forco's foreign borrowings. Instead, the water's edge approach incorrectly presumes that $500 (50% x $1,000) of USP's domestic interest was incurred to finance Forco operations even though that is clearly not the case (*i.e.*, both USP and Forco have an equal amount of assets, are equally leveraged, and have independently incurred debt for specific reasons pertaining to their own distinct operations). A more appropriate approach that more fully adopts the concept of fungibility is illustrated under the worldwide allocation. None of the U.S. interest expense is allocated to foreign sources under this method because, unlike the water's edge approach, this approach recognizes the fact that Forco has itself incurred interest expense.[40] In the end, USP will incur double taxation unless it can somehow generate unrelated low-tax income to absorb its credit carryover.

[40] $2,000 of worldwide interest allocated 50 percent to Forco operations and 50 percent to U.S. operations results in a $1,000 allocation to both U.S. and foreign sources. Thus, no additional allocation of interest to U.S. sources is necessary.

Example 3 Illustration of Interest Allocation Rules

	Water's Edge Interest Allocation	Worldwide Interest Allocation
U.S. Taxable Income of USP		
Domestic Income	1,000	1,000
Dividend from Forco	700	700
Section 78 Gross-up of Deemed Paid Taxes	300	300
Taxable Income	2,000	2,000
Tax Rate	35%	35%
U.S. Tax Before Credits	700	700
Foreign Tax Credit Calculation		
Foreign-Source Income (With Section 78 Gross-up)	1,000	1,000
Allocation of Interest	(500)*	–**
Foreign-Source Income After Allocation	500	1,000
Section 904(a) Limitation:		
500 / 2,000 X 700	175	–
1,000 / 2,000 X 700	–	350
Foreign Tax Credit (Lesser of Limitation or 300)	175	300
U.S. Tax Liability After Credit	525	400
Foreign Tax Credit Carryover	125	–

Interest Allocation Calculation:

* USP's interest of $1,000 is allocated 50% to U.S. sources and 50% to foreign sources. Forco's interest expense of $1,000 is not considered.

** Worldwide interest of $2,000 is allocated 50% to USP and 50% to Forco. Forco's interest expense of $1,000 is considered. As a result, none of the U.S. interest is allocated to foreign sources.

2. Comparison of U.S. Rules to Rules of Foreign Countries

From a competitive perspective, the interest allocation rules are a double-edged sword. They not only limit a U.S. multinational's ability to compete abroad, they also limit a U.S. multinational's ability to compete in the U.S. market against foreign and domestic competitors.

a. Competition Abroad

No other country in the comparison requires an allocation of interest using fungibility principles; instead, these countries generally trace interest expense directly to the use of the funds. As a result, multinationals in these countries do not incur the double taxation illustrated in Example 3. Indeed, Canada, Germany, and France even allow a deduction for interest expense related to holding shares of foreign subsidiaries that generate exempt income.

b. Competition in the United States

U.S. multinationals are also at a disadvantage when competing in the U.S. market because an incremental borrowing by a U.S.-based multinational to build a facility or expand its operations in the United States results in a portion of its interest expense on the new loan being allocated to foreign-source income. As illustrated above, this results in double taxation. A U.S. subsidiary of a foreign-based multinational, or, for that matter, an unaffiliated U.S. corporation that borrows funds in the United States to build a plant or expand U.S. operations does not have to allocate its interest expense and it will receive a full benefit for its interest deduction. Consequently, it has a competitive advantage over a U.S.-based multinational in the U.S. market.

3. Conclusion

If the United States truly wishes to embrace fungibility and put U.S. multinationals on a level footing with their foreign competitors, its current one-way approach that ignores foreign borrowings must be replaced by a global fungibility allocation.

C. Overall Foreign Loss Rules

The U.S. OFL rules provide another example of the complexity and slant of the U.S. international tax provisions. An OFL is created whenever foreign-source deductions for a particular year exceed foreign-source income for the same year (*i.e.*, there is a net foreign loss). Under U.S. law, an OFL is deductible against a taxpayer's domestic-source income; however, subsequent foreign-source income of the taxpayer must be "recaptured." More specifically, it must be recharacterized as U.S.-source income. The amount recharacterized in a particular year is limited to 50 percent of the taxpayer's foreign-source income for the year unless an election is made to re-source a higher percentage.

1. Purpose of Overall Foreign Loss Rules

The OFL rules are designed to prevent a taxpayer from obtaining a double benefit from a foreign loss—first, the benefit of a deduction against U.S.-source income, and then, the benefit of a foreign tax credit on subsequent foreign-source income unreduced by the previous loss.

For example, assume that USP, a U.S. multinational, generates a $1,000 Country X loss and $1,000 in U.S.-source income during year 1. In year 2, USP generates an additional $1,000 of U.S.-source income and $1,000 in Country X-source income on which $350 Country X tax is paid (this might occur if Country X does not allow USP a carryforward for its year 1 loss). These assumptions are summarized below.

Example 4 Illustration of OFL Rules

Taxable Year	Country X Income	Foreign Tax	U.S.-Source Income	Taxable Income	U.S. Tax— No OFL Rules*	U.S. Tax With OFL Rules**
Year 1	(1,000)		1,000	–	–	–
Year 2	1,000	350	1,000	2,000	350	700

Foreign Tax Credit Calculation:

* Without recapture of the Year 2 Country X income as U.S.-source, the foreign tax credit limitation is $350.
[($1,000 foreign-source income/$2,000 taxable income) x $700 pre-credit U.S. tax]

** With recapture of the Year 2 Country X income as U.S.-source, the foreign tax credit limitation is $0.
[($0 foreign-source income/$2,000 taxable income) x $700 pre-credit U.S. tax]

The example illustrates the intention of the OFL rules. USP has $2,000 of U.S. income and no Country X income over a two-year period. As a result, the U.S. tax on a cumulative basis should be $700 ($2,000 x 35%). Without the OFL rules, however, USP pays only $350 in U.S. tax. It receives a double benefit—first, a deduction for the year 1 foreign loss and then a foreign tax credit in year 2 that does not reflect the year 1 loss. The OFL rules prevent this result by recharacterizing $1,000 of USP's Country X income earned in year 2 as U.S.-source income. In this way, the foreign tax credit computation reflects the fact that over a two-year period no foreign-source income has been earned.

In essence, this rule protects the U.S. tax base (*i.e.*, USP's $2,000 of domestic income) by forbidding a credit for excessive foreign taxes. In this case, the Country X tax of $350 was excessive since no cumulative income existed in Country X. It is worth noting that if Country X allowed loss carry-forwards, USP would probably be indifferent about OFL recapture since no Country X tax would be paid in year 2.

2. Double Taxation Caused by Overall Foreign Loss Rules

Although the theory behind the OFL rules appears sound, these rules often produce unnecessarily harsh results when applied in practical situations. This can be illustrated by expanding the previous example. Assume that USP has additional operations in Country Y and that these operations break even in year 1 and generate $2,000 of Country Y-source income in year 2 on which $700 Country Y tax is paid. Additionally, assume that Country X operations generate a $1,000 Country X loss in year 1, and in year 2 and beyond they break even, as they are unable to generate a profit due to substantial start-up costs required to penetrate the Country X market. These assumptions are summarized below.

Example 5 Illustration of OFL Rules

	Calculation Using OFL Rules		Calculation Without OFL Rules	
	Year 1	Year 2	Year 1	Year 2
US Taxable Income of USP:				
Domestic Sources	1,000	1,000	1,000	1,000
Foreign Sources (Country X)	(1,000)	–	(1,000)	–
Foreign Sources (Country Y)	–	2,000	–	2000
US Taxable Income	–	3,000	–	3,000
US Tax Before Credits (35%)	–	1,050	–	1,050
Foreign Tax Credit (Lesser of Limitation or $700 Actually Paid)	n/a	(350)	n/a	(700)
US Tax Liability After Credit	NONE	700	NONE	350
Foreign Tax Credit Carryover	n/a	350*	n/a	NONE
Foreign Tax Credit Calculation:				
Current Year Foreign-Source Income Prior to OFL Resourcing	(1,000)	2,000	(1,000)	2,000
Recapture of Year 1 Loss as Domestic-Source	–	(1,000)	–	n/a
Foreign-Source Income after OFL Resourcing	(1,000)	1,000	(1,000)	2,000
Section 904(a) Limitation:				
1,000/3,000 x 1,050		350		
2,000/3,000 x 1,050				700

* Unless Country X operations generate $1,000 of income before expiration of the carryforward period, this $350 carryforward will go unused.

In this example, a portion of USP's Country Y earnings will be double taxed unless the Country X operations generate income within the five-year foreign tax credit carryforward period sufficient to offset the year 1 loss. Since this income is unlikely to arise due to Country X operations being in the start-up phase, $1,000 of USP's Country Y income will be double taxed (*i.e.,* USP's $3,000 of cumulative worldwide income will be subject to a 47 percent worldwide tax rate).[41]

It should be noted that the generation of Country Y foreign-source income during this period is of little use. This income does not generate excess limitation and thus USP is only able to credit the current year taxes associated with this income.

3. Asymmetry of Overall Foreign Loss Rules

The asymmetry of the OFL rules clearly exposes their undue harshness. Although these rules require the recapture of foreign losses, they do not require recapture for U.S. losses that offset foreign-source income.[42] For instance, a U.S. multinational might generate a $1,000 domestic loss and $1,000 of foreign income on which it pays $350 foreign tax. Under U.S. law, the company's foreign-source income is reduced to zero and the entire $350 in foreign taxes cannot be credited. In the following year, if the U.S. multinational has $1,000 of U.S.-source income and $1,000 of foreign-source income (subject to an additional $350 foreign tax), there is no recapture of the previous U.S. loss. Without such recapture, the U.S. multinational's foreign-source income in its foreign tax credit limitation formula will be understated on a cumulative basis and double taxation will occur.

4. Other Consequences of Overall Foreign Loss Rules

U.S. multinationals are often prevented from repatriating foreign earnings as a result of the interaction of U.S. OFL and interest allocation rules. This occurs because many U.S. multinationals forego dividend payments and reinvest their foreign subsidiaries' earnings for extended periods of time. Although no dividends are received during these years, U.S. interest deductions are still allocated to foreign sources based on the U.S. parent's basis in its foreign stock. This expense is often the single largest expense on the books of large, capital intensive operations. Moreover, the interest

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[41] $700 U.S. tax plus $700 Country Y tax divided by cumulative income of $3,000.

[42] U.S. losses are allocated proportionately against the foreign-source income in each of the separate limitation baskets.

is allocated even if the foreign operations are financed by foreign debt (see B., above). The net effect is that a substantial OFL is usually generated during reinvestment years.

Years later, when the U.S. parent wishes to receive these foreign earnings it almost certainly faces double taxation on a portion of its dividend. One might argue that double taxation does not necessarily occur at this point—that the OFL merely represents an accumulation of the interest expense allocated under the U.S. interest allocation rules, the effect of which is not suffered until a dividend is received—but this presumes that the interest allocation rules and the OFL rules do not themselves cause double taxation, which, as shown above, is not the case. In essence, the receipt of such a dividend is simply the culmination of deferred double taxation. As a consequence, U.S. multinationals are often reluctant to take back dividends from their foreign subsidiaries, notwithstanding the existence of a legitimate U.S. business need for the cash.

5. Anti-competitiveness of U.S. Overall Foreign Loss Rules

None of the countries surveyed have rules similar to the U.S. OFL rules. Only the Netherlands has provisions that are at all comparable. However, unlike the U.S. rules, the Dutch rules treat domestic and foreign losses equally. Thus, when a domestic loss reduces a Dutch taxpayer's access to exemption, an indefinite carryforward equal to the domestic loss is created so that the previously denied exemption is restored when subsequent domestic income arises (see III.D.1.a., above, for an explanation of why domestic losses reduce the Dutch exemption). Loss re-sourcing is not an issue with the other exemption systems because they do not reduce their exemptions for foreign income when a domestic loss is incurred.

It also should be noted that, with the exception of the Netherlands and Canada (see D.2., below, for Canada's solution to domestic losses), the other credit systems fail to address domestic losses as well. Multinationals in these countries that operate at a profit abroad, but at a loss domestically, obtain no relief in this regard. Still, not a single country has adopted entirely one-sided rules like those of the United States.

6. Conclusion

The considerable complexity and administrative burden associated with the OFL rules, the double tax burden they impose, and the fact that competitors are not encumbered by a similar burden puts U.S.-based multinationals at a competitive disadvantage. As a minimum, it only seems fair that the uneven treatment of domestic and foreign losses should be eliminated. The current heads-I-win, tails-you-lose philosophy is not only inconsistent, it is inequitable.

D. Foreign Tax Credit Carryover Mechanisms and Other Methods of Dealing with Excess Foreign Tax Credits

A carryover mechanism is vital to any credit system. Without it, double taxation might occur simply because concurrent taxing jurisdictions utilize different tax accounting principles or because a taxpayer's income fluctuates from year to year. For this reason, most of the credit regimes of the selected countries have some form of carryover mechanism. Although the carryover periods of these regimes differ, with the United States' two-year carryback and five-year carryforward falling somewhere in the middle, the carryover mechanisms operate in essentially the same manner.[43]

A few of the countries' carryover mechanisms contain uniquely advantageous features that might, if adopted by the United States, substantially reduce the double tax burden of U.S.-based multinationals.

1. Deduction for Excess Credits

The credit regimes of Germany and Canada (with respect to non-business tax credits only) do not permit carryovers to the extent foreign taxes exceed their credit limitations in a particular year. Though these systems are harsher than the U.S. system in this regard, this harshness is mitigated to some extent because Germany and Canada allow excess taxes to be deducted in the year in which they arise.[44]

This may not seem very favorable since credits are clearly preferable to deductions. However, taxpayers that are chronically in an excess credit position might favor such a deduction over the establishment of an additional credit carryforward that is likely to expire. In this way, some benefit can be derived from these otherwise uncreditable taxes.

[43] Canada has three-year carryback and seven-year carryforward periods for business income tax credits. Excess taxes on non-business income can only be deducted. Japan has a three-year carryforward period for both excess credits and excess limitation. The United Kingdom allows excess EUFT on dividends to be carried back three years and forward indefinitely, but provides no carryforward for taxes on branch income. Germany does not permit a carryforward for excess taxes under its credit system, but does permit a deduction. The Netherlands and France, which employ the credit system on a limited basis, have an unlimited carryforward period and a five-year carryforward period respectively.

[44] The limited French credit system allows either a carryover or a deduction for excess foreign taxes.

2. Adjustments for Insufficient Domestic Tax

Relief under a credit system is predicated on the existence of a domestic tax liability.[45] Insofar as there is no domestic tax liability because of domestic or foreign losses, excess credits usually arise. Even though most systems allow these excess credits to carryover, the credits often expire unused. This might occur because the credit system has no recapture provision for domestic losses (see C., above) or because the taxpayer is simply unable to generate domestic income within the credit carryover period.

For example, suppose that in year 1 a multinational corporation generates $100 of foreign-source income, incurs a $100 domestic loss and pays $35 of foreign tax. In this case, the multinational has no domestic taxable payable. Accordingly, none of the $35 in foreign taxes is creditable under the credit limitation for that year. If, in year 2, the multinational corporation generates $100 of domestic income and $100 of foreign income, each subject to a 35 percent tax, the multinational will still be unable to credit its carryforward absent some adjustment to compensate for the lack of a domestic tax liability in the previous year.[46]

Canada is the only country with carryover provisions that effectively deal with this problem.[47] If a loss prohibits a Canadian multinational from utilizing foreign tax credits in a particular year, it can convert its foreign tax credits into an equivalent increase in its net operating loss deduction. In doing so, it preserves the benefit of these taxes for a substantially longer period of time, and, more importantly, it avoids the need to generate future excess limitation income.

[45] Exemption systems usually do not encounter this issue. They provide relief irrespective of whether a domestic tax liability exists.

[46] In the example, the corporation's year 2 foreign tax credit will be limited to $35 [($100 foreign-source income/$200 worldwide income) x $70 domestic tax], which is only enough to absorb the $35 of year 2 taxes. There is, therefore, double taxation with respect to the year 1 foreign taxes, even though a credit carryforward may be allowed. The cumulative income of $200 over two years is taxed at a 70 percent rate [($70 of combined year 1 and year 2 foreign tax plus $70 of domestic tax in year 2) divided by $200 of cumulative income].

[47] Another way to address this problem would be re-sourcing rules for domestic losses similar to those currently applicable to U.S. foreign losses. For instance, if the $100 of year 2 domestic income in the above example were re-sourced as foreign-source income during year 2, the credit limitation would correspondingly increase so that the taxes from year 1 would be creditable. (*See* Example 5 for additional discussion of this issue).

Table 5–1

Country	Basic method of taxation	Types of double taxation relief available	General limitations imposed on double tax relief
Canada	Worldwide income except income from treaty countries, which is exempt.	Mixed credit and exemption system.	Per country credit limitation with business and non-business baskets. Exemption limited to active business income earned in treaty countries.
France	Generally taxed only on French source income.	Primarily exemption system with limited use of credit system.	Exemption limited to active business income.
Germany	Worldwide income except income from treaty countries, which is exempt.	Mixed credit and exemption system.	Per country credit limitation with no basketing rules. Fifteen percent of exempt income subject to German tax. Exemption limited in some cases if income is not subject to foreign tax.
Japan	Worldwide income regardless of geographic origin.	Credit system.	Overall credit limitation. Certain high-rate taxes may not be creditable. Two-thirds of untaxed income excluded from numerator of calculation. Ninety percent maximum limitation ratio.
Netherlands	Generally taxed only on Dutch source income.	Primarily exemption system with limited use of credit system.	Exemption generally only applies to active business income subject to tax in a foreign jurisdiction.
United Kingdom	Worldwide income regardless of geographic origin.	Credit system.	Item-by-item credit limitation, but can be avoided on foreign dividends through use of onshore pooling regime.
United States	Worldwide income regardless of geographic origin.	Credit system.	Credit limitation computed for nine different baskets using detailed look-through rules.

Interest allocation rules	Loss resourcing rules	Credit carryover rules
Detailed rules do not exist. Interest expense related to exempt holdings is deductible.	No loss resourcing rules. However, if domestic loss prevents use of the credit, taxpayer can transform credit into an equivalent NOL amount.	No carryover for excess non-business credits, but excess may be deducted. Excess business credits may be carried back three years and forward seven.
Detailed rules do not exist. Interest expense related to exempt holdings is deductible.	No loss resourcing rules.	Limited use of credit system. Credit system allows for a five year carryforward of unused credits.
Detailed rules do not exist. Interest expense related to exempt holdings is deductible.	No loss resourcing rules.	Excess credits may not be carried back or forward, but excess can be deducted.
Detailed rules do not exist.	No loss resourcing rules.	Both excess credits and excess limitation can be carried forward three years.
Interest on loans entered into within six months may not be deductible if related to the acquisition of a foreign participation. Otherwise detailed rules do not exist.	Both foreign and domestic loss recapture rules apply to proportional deduction on branch income.	Limited use of credit system. Credit system allows for indefinite carryover of unused credits.
Detailed rules do not exist.	No loss resourcing rules.	No carryover for unused credits except for excess “EUFT” under the onshore pooling regime, which can be carried back three years and forward indefinitely.
Detailed rules requiring allocation of interest on a water’s edge basis using adjusted bases or fair market values of assets.	Detailed rules require only resourcing of foreign source income subsequent to an overall foreign loss. Similar rules for domestic losses offsetting foreign income do not exist.	Excess taxes carried back two years and forward five years.